IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-853

HAROLD CRAMER, Custodian for Patricia Gail Cramer,
Petitioner,

vs.

GENERAL TELEPHONE & ELECTRONICS CORPORATION, LESLIE H. WARNER, THEODORE F. BROPHY, JOHN J. DOUGLAS, WILLIAM F. BENNETT and ARTHUR ANDERSEN & CO.,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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TABLE OF CONTENTS

PAGE

TABLE OF CITATIONS—(*Continued*)

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The petitioner, Harold Cramer, Custodian for Patricia Gail Cramer, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals in this proceeding on July 18, 1978.

OPINION BELOW

The opinion and judgment of the Court of Appeals for the Third Circuit, unofficially reported in CCH Fed. Sec. L. Rep. ¶ 96,510, at 93, 981 (3rd Cir. 1978), appears as Appendix A hereto. The opinion of the United States District Court for the Eastern District of Pennsylvania, reported in 443 F Supp. 516 (E.D.Pa. 1977), appears as Appendix B. The judgment of the Court of Appeals for the Third Circuit denying Rehearing appears as Appendix C.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on July 18, 1978. The jurisdiction of this Court is invoked under Title 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

I. Is the Third Circuit Court of Appeals' interpretation of Fed. R. Civ. P. 23.1's procedural "particularization" requirement, upon which the Complaint was dismissed, contrary to both the interpretations and decisions of other Circuits?

II. Alternatively, if the Third Circuit Court of Appeals correctly interpreted Fed. R. Civ. P. 23.1.'s procedural "particularization" requirement, in dismissing this case did it depart from the accepted and usual course of judicial proceedings by failing to remand the case to the District Court with leave to amend?

STATUTORY PROVISION INVOLVED

Rule 23.1, Federal Rules of Civil Procedure, is set out in Appendix D.

STATEMENT OF CASE

This is a shareholder derivative suit brought by Harold Cramer ("Petitioner"), the custodian of common stock of General Telephone & Electronics ("GTE") for Patricia Gail Cramer pursuant to the Pennsylvania Uniform Gift to Minors Act, against GTE, four of the members of its Board of Directors ("Board"), and its auditor, Arthur Andersen & Co. The suit contends that the defendants(1) violated Sections 10(b), 12(b)(1), 13(a) and 14(a) of the Securities Exchange Act of 1934 [15 U.S.C. §§ 78j(b), 781(b) (1), 78m(a), and 78n(a)], (2) defrauded GTE in violation of New York state law (GTE's state of incorporation), and (3) breached their common-law fiduciary duties to GTE. The action, filed on June 18, 1976, was originally brought in the United States District Court, Eastern District of Pennsylvania. The jurisdiction of that Court was invoked under 28 U.S.C. § 1332.

The Complaint alleges that defendants' illegal acts consisted of the payment of commercial bribes, kickbacks, unearned commissions, the creation of "slush" funds, the transfer of a GTE subsidiary, the falsification of GTE's financial statements and the concealment of said acts. *See* Complaint, paras. 14 and 15. These allegations were borne out via a report prepared by an Audit Committee of the Board, dated March 4, 1976, and distributed to GTE's shareholders as part of a proxy statement prior to the stockholders' annual meeting on April 21, 1976. The Audit Committee specifically found that defendants, Leslie H. Warner (Chairman of the Board) ("Warner"), Theodore F. Brophy (President of GTE) ("Brophy"), John J. Douglas (Executive Vice-President of Finance) ("Douglas") and William F. Bennett (Executive Vice-President, Manufacturing Group) ("Bennett") were personally involved, in varying degress, in the illegal acts alleged herein. *See* Complaint, Exhibit "A". The Audit Committee consisted of four members of the Board who, although assumedly not involved in the illegal activities, were "outside" directors throughout the time period in which the acts occurred: William M. Fuller, John H. Knowles, John H. Paze and James W. Walter. Despite its findings, the Audit Committee

not only failed to pursue legal action, it, incredibly, failed to discuss even the *possibility* of litigation.[1]

Petitioner commenced this action without making a "demand" on the Board to institute suit. *See* Fed. R. Civ. P. 23.1. Based on the failure of the Audit Committee to pursue litigation and the composition of both the Board and the Audit Committee, petitioner has contended that to do so would have been "futile". *See* Complaint, para. 13.

On August 22, 1977, the District Court below granted defendants' Motion for Summary Judgment as to the §§ 13(a), 14(a) and pendant state law claims. The basis for granting this motion was the Court's holding that prior decisions in *Auerbach* and *Limmer* precluded it from considering the instant case, under the doctrine of res judicata.[2] Though the District Court did not find that the claims under Section 10(b) were barred by res judicata, it dismissed the § 10(b) and Rule 10b-5 claims for failure to state a claim upon which relief can be granted, pursuant to Rule 12(b)(6) of the Fed. R. Civ. P. The § 12(b)(1) claim was also dismissed under Fed. R. Civ. P. 12(b)(6), for lack of compliance with the standing requirements of Section 18(a) of the Securities Exchange Act of 1934 [15 U.S.C. § 78r(a)].

Petitioner thereafter appealed the decision of the District Court to the Third Circuit Court of Appeals ("Court of Appeals"). On July 18, 1978, the Court of Appeals affirmed the decision of the District Court granting defendants' Motions to Dismiss and for Summary Judgment. But the Court of Appeals,

[1] The Audit Committee's Action (more appropriately, *inaction*) precipitated the filing of three separate derivative suits in different forums, the instant case being the last filed:

-*Auerbach v. Bennett*, Civil Action No. 572-77 (Sup. Ct. of N.Y., Westchester County, filed March 16, 1976) ("*Auerbach*").

-*Limmer v. General Telephone & Electrics Corp.*, Civil Action No. 76-1494 (S.D.N.Y., filed March 30, 1976) ("*Limmer*").

Essentially, the *Auerbach* suit alleged that the same defendants as herein breached their fiduciary duties to GTE. The *Limmer* suit charged that Warner, Brophy, Douglas and Bennett had violated §§ 13(a) and 14(a) of the Securities Exchange Act of 1934, and did not name Arthur Andersen & Co. as a defendant.

[2] For a concise discussion of the respective court's holding in *Auerbach* and *Limmer*, see *Cramer v. General Telephone & Electronics Corp.*, CCH Fed. Sec. L. Rep., ¶96,510, at 93,981-93,982, attached as Appendix A. ("*Cramer*").

in affirming dismissal, held that a valid § 10(b) claim was alleged. However, the § 10(b) claim was dismissed, and consequently the complaint without leave to amend, for failure to comply with the demand requirements of Rule 23.1.

Finally, petitioner subsequently filed a Petition For Rehearing with the Court of Appeals. On August 28, 1978, said Petition was denied.

REASONS FOR GRANTING THE WRIT

I. The Third Circuit Court of Appeals' interpretation of Fed. R. Civ. P. 23.1's procedural "particularization" requirement, upon which the complaint was dismissed, is contrary to both the interpretations and decisions of other Circuits.

Federal Rule of Civil Procedure 23.1 requires, in pertinent part, that in a shareholder derivative action ". . . [t]he complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff [shareholder] to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort." Thus, although a shareholder need not make an effort to secure the desired action from the Board of Directors in every case, he must particularize the reasons for not doing so. Judicial interpretations of this provision of Rule 23.1, as noted by one prominent commentator, have served to create an absence of ". . unanimity of opinion amongst the courts . . ." as to what constitutes compliance with the procedural requirement of "particularization." 3 B Moore's *Federal Practice*, 23.1.19 at 83 (2d, Ed. 1974). However, despite the *acknowledged inconsistency* amongst the Circuits, the preferable and prevailing view has been one of leniency in sustaining allegations of "futility"[3] of demand. *See Hanna v. Plumer*, 380 U.S. 460 (1965) (certiorari granted due to threat to goal of federal procedural unanimity).

In the instant case, paragraph 13 of the Complaint succinctly sets forth the basis for petitioner's lack of demand on the Board:

> "Plaintiff has made no demand upon the Board of Directors of General (herein "the Board"), to bring and prosecute this action. Such a demand would have been futile since the Board has already conducted an investigation of the facts alleged, as set forth in the Proxy statement attached hereto and made part hereof as Exhibit "A", and made recommendations none of which include the remedies requested herein. Further, the Board is dominated by the individual defendants herein and it is unreasonable to believe they would authorize suit to be brought against themselves. Further, the Board consists of fourteen persons, four of whom are named as defendants herein, one of whom (Charle G. Farris) is an employee of General and dominated by individual defendants herein, and four of whom, as outside directors (William M. Fuller, John H. Knowles, John H. Paze, and James W. Walter) conducted the investigation and failed to recommend the actions and remedies herein demanded."

[3] The term "futile" has been generically applied by the courts to encompass those situations where, based on the allegations of the complaint *et al.*, a demand is justifiably forgone. *See, e.g. Smith v. Sperling*, 354 U.S. 91 (1957); *Jannes v. Microwave Communications, Inc.*, 57 F.R.D. 18,21 (N.D. Ill. 1972).

Analyzing the Complaint, it is readily apparent that petitioner's "futility" argument consisted of three key ingredients:

1. The four defendant-directors were also the chief operating officers of GTE. Due to their illegal activities and respective positions of domination, it would be unreasonable to believe that they would authorize a lawsuit to be brought against themselves.

2. The other four members of the Board who conducted the Audit Committee investigation (Fuller, Knowles, Paze and Walker) had full knowledge of all the facts upon which this action was based and took no action at this point in time, and, it could reasonably be assumed that they would take no action thereafter. These individuals plus the four defendant-directors constituted a majority of the Board.

3. The Board, so comprised and will full knowledge of all the facts (via personal participation[4] and the Audit Committee findings) upon which this lawsuit is based, failed to take any legal action whatsoever.[5]

[4] Parenthetically, the defendant-directors conduct violated, *inter alia*, Sections 180.00 (Commercial Bribing in the Second Degree), 180.03 (Commercial Bribing in the First Degree) and 200 (Bribery in the Second Degree) of the New York Penal Code. 39 McKinney's Consolidated Laws of New York, §§ 180.00, 180.03 and 200.

[5] On April 26, 1976, the Board simply created a "Special Litigation Committee" to assess GTE's position with respect to the *Auerbach* and *Limmer* allegations. The Board subsequently authorized this Committee to evaluate those of the instant lawsuit. Without disputing the findings of fact made by the Audit Committee Report, this Committee ultimately concluded that all these actions should be *opposed* by GTE:

> "The Special Litigation Committee advised GTE's General Counsel to take the position in *Limmer* and *Cramer* that the federal claims were meritless, that the state-law claims should be dismissed for lack of subject

Summarily examining these allegations and their implications, the Court of Appeals dismissed the Compaint (§ 10(b) and Rule 10b-5 claims) for failure to particularize "futility":

> ". . . Cramer's complaint *does not adequately explain* why he failed to make a demand upon the directors. Cramer correctly states that the Audit Committee did not recommend litigation against the directors. But so far as the complaint discloses, that Committee had not been instructed to determine whether litigation against the directors would be appropriate. Its primary functions were to examine GTE's foreign business transactions, to disclose any questionable overseas payments, and to suggest internal procedures for remedying the prior practices. We do not believe that the Audit Committee's report necessarily demonstrated management's opposition to an action against the directors who had participated in the foreign activities in which the payments had been made. . . . The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight. At the time Cramer filed his complaint, the Board of Directors had not yet expressed opposition to such derivative actions.
>
> Nor do we think that the defendants herein so dominated the Board of Directors as to made a demand on the Board futile. At the time Cramer commenced this suit, there were 14 individuals on GTE's Board of Directors. Only four of these were named as defendants in this action. The remaining ten directors had not been involved in the allegedly fraudulent activities. Indeed several of the directors had not even been members of the Board at the time the questionable transactions occurred. Under these circumstances, we cannot agree with Cramer that the four directors named as defendants in the instant case dominated the Board to such an extent that the plaintiff should be excused from the mandatory requirement of Rule 23.1 that he first make a demand on the directors." (footnote omitted). (emphasis added).
>
> *Cramer, supra* at 93,991

matter jurisdiction, and that the suits, even if meritorious, were not in the best interests of GTE or its shareholders and thus should not be prosecuted on GTE's behalf. The Committee recommended that the *Auerbach* action should be opposed as being contrary to the best interests of GTE or its shareholders." [footnote omitted] Cramer, Supra. at 93,981.

The Committee arrived at the startling conclusion that the lawsuits would take time and money and, therefore, would not be in the best interests of GTE. *See, Report of the Special Litigation Committee of the Board of Directors of General Telephone & Electronics*, pps. 17-22. GTE apparently feels that it is neither worth the time nor the money to determine the extent of its own corruption. Petitioner contends that this Committee's "assessment" was inadequate, in that the full extent of GTE's improper activities were not ascertained. This view is shared by the Securities and Exchange Commission, which delayed a five million (5,000,000) share offering of GTE Common Stock on December 13, 1976, and again on December 14, 1976, because GTE had not disclosed enough about improper payments. *See* Wall Street Journal articles of December 14 and 15, 1976, attached as Exhibit "B" to Plaintiff's Memorandum in Opposition To Motion of Defendant GTE To Dismiss the Complaint for Summary Judgment.

It is respectfully submitted that the Court of Appeals' interpretation of Rule 23.1's "particularization" requirement in the instant case is contrary to both the interpretations and decisions of the Second, Tenth, Fifth, Seventh and Ninth Circuits.

The Second Circuit, which has been in the forefront of the prevailing view of leniency in pleading futility, has looked primarily at the antagonism, adverse interest or involvement the "controlling" directors (or shareholders) possess. *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F.2d 85 (2nd Cir. 1955) (court construed Rule 23(b), predecessor of Rule 23.1). In *Papilsky v. Berndt*, 59 F.R.D. 95 (S.D.N.Y. 1973), a shareholder derivative suit was commenced in which it was alleged that demand was futile due to the fact that the unaffiliated directors were "controlled" by the affiliated.[6] The complaint asserted that the element of control was brought about by the "strategic positions" of the affiliated directors, who were also the principal officers of the derivatively-sued company. Defendants moved to dismiss the complaint, arguing that the allegation of domination and/or control was insufficiently precise for purposes of Rule 23.1. The District Court denied the motion to dismiss, and held that this allegation of "control" was "sufficiently particular." *Papilsky, supra* at 97. Analogizing the *Papilsky*

[6] The "unaffiliated" directors comprised a majority of the Board of defendant, Affiliated Fund, Inc., ("Fund") on whose behalf the action was brought. The "affiliated" directors, who were in the minority on the derivatively-sued Fund's Board, were the partners in the management company accused of improper management practices vis-a-vis Fund. 59 F.R.D. 95, 96.

rationale to the instant case, it is clear that petitioner's Complaint particularizes domination and/or control by the defendant-directors over GTE's Board. It is alleged that defendant Warner is Chairman of the Board, defendant Douglas is Executive Vice-President of Finance, defendant Bennett is Executive Vice-President of Manufacturing Group and defendant Brophy is President. It is implicit in this situation, as in *Papilsky*, that the "strategic" positions held by these individuals provided them with control over GTE and its Board. This element of domination and/or control is further confirmed by the fact that the Audit Committee (comprised of the four outside directors who, with the defendant-directors, constitute a majority of GTE's Board), despite obtaining information concerning the illegal transactions herein, took no appropriate legal action.[7] Therefore, under the Second Circuit's *Papilsky* rationale, petitioner's complaint "adequately explained" why a demand was not made and was improperly dismissed[8]. *Accord: Abbe v. Goss*, 411 F. Supp. 923 (S.D.N.Y. 1975). *See Cathedral Estates, Inc. v. Taft Realty Corp., supra,* (cited and followed in *Papilsky*); *Dopp v. American Electronic Laboratories, Inc.* 55 F.R.D. 151 (S.D.N.Y. 1972). *See also, Brick v. Dominion Mortg. & Realty Trust*, 442 F. Supp. 283 (W.D.N.Y. 1977) (demand on directors excused in view of allegations; derivative 10b-5 claim dismissed for failure to comply with Massachusetts' minority "business decision" rule). *But see, Brooks v. American Export Industries*, 68 F.R.D. 506, (S.D.N.Y. 1975). Likewise, the Tenth Circuit has excused demand once "domination" is so established. *de Haas v. Empire Petroleum Co.*, 286 F. Supp. 809, *aff'd*, 435 F.2d 1223 (10th Cir. 1970); *Walden v. Elrod*, 72 F.R.D. 5 (W.D. Okla. 1976).

In essence, the defendant-directors and the Audit Committee (a controlling majority of the Board) "ratified" the illegal transactions et al. complained of, the former by their personal

[7] It should be noted that Charles G. Farris, a member of the Audit Committee, was also an employee of GTE. Mr. Farris, it is submitted, would be unable to make an unbiased, informed decision to authorize suit against the defendants, who had the power to remove him from his position.

[8] In holding that the Board was not "dominated" in order to excuse demand, the Court of Appeals never considered the crucial fact that the four defendant-directors and the four Audit Committee directors constituted a "controlling majority".

involvement and the latter by its failure to instigate legal action despite its knowledgeability. In a somewhat similar situation, the Fifth Circuit was held that,

> ". . . given plaintiff's allegations that all of the trustees either actively participated in the wrongful transactions *or, at the least approved or ratified such transactions with knowledge or notice of their illegality*, the court concludes that demand upon the trustees to bring this action should be excused." (emphasis added).
>
> *Oldfield v. Alston*, 77 F.R.D. 735, 740 (N.D. Ga. 1978)."

As pointed-out by the Court of Appeals in the instant case,

> "[t]he futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced . . ."
>
> *Cramer, supra* at 93,991.

As was previously noted, at the time this case was filed, eight directors (four by personal involvement, four by ratification) had clearly indicated their disposition on the matter of suit. *See* Complaint, para, 13 and Exhibit "A" attached thereto. Any demand on the Board, its majority so comprised, would certainly have been futile.[10] The *Oldfield* court's rationale was buttressed by an earlier Fifth Circuit decision that focused on the "ac-

[9] The *Oldfield* court, in finding that "ratification" plus knowledge of the illegal transactions equalled futility of demand, considered *In re Kauffman Mutual Fund Actions*, [479 F.2d 257 (1st. Cir.), *cert. denied*, 414 U.S. 857 (1973)] and its progeny, a line of predominantly First Circuit cases expressing conservative treatment of shareholder derivative actions. The Court distinguished the *Kauffman* line of cases on the basis of sufficiency of ratification. For First Circuit cases relying on the *Kauffman* "restrictive view", *see, e.g., Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977); *Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass. 1978); *GA Enterprices, Inc. v. Leisure Living Communities, Inc.*, 66 F.R.D 123 (D. Mass. 1974). To the same effect in other Circuits, *see, e.g., Jones v. Equitable Life Assurance Society of U.S.*, 409 F. Supp. 370 (S.D.N.Y. 1975); *Royston v. Eastern Empire Corp.*, 393 F. Supp. 1010 (E.D. Pa. 1975). *Kauffman* and its progeny, and clearly the First Circuit, continue to oppose the "leniency" employed by many of the Circuits in sustaining futility allegations in derivative suits.

[10] As held by the Seventh Circuit, when ". . . the message is loud and clear . . ." that the majority of a Board of Directors are opposed to bringing the action, Rule 23-1's futility requirement is satisfied. *Nussbacher v. Continental Ill. Nat. B. & T. Co., Chicago*, 518 F.2d 873, 878-79 (7th Cir. 1975). *Accord: Jannes v. Microwave Communications, Inc., supra.* The Board's "message" herein was extremely "loud and clear" at the time this lawsuit was filed, for the *Auerbach* complaint was filed a month earlier and it (Board) did not bring suit on behalf of GTE, despite its duty to do so.

quiescence in or approval of" the acts complained of by the controlling-majority directors. *Liboff v. Wolfson*, 437 F.2d 121 (5th Cir. 1971). In *Liboff*, the trial court dismissed plaintiff's complaint on the ground that it failed to comply with Rule 23.1. The complaint alleged as follows:

> "Demand by plaintiff that the Board of Directors of the Corporation bring this action would have been futile. The majority of said directors participated, *approved of and acquiesced* in said transaction and are liable therefor. The directors of the Corporation would not and could not diligently prosecute this action because they would have to bring it against themselves which would prevent its effective prosecution." (emphasis added).
> 437 F.2d 121,122.

The Fifth Circuit Court of Appeals reversed the lower court's dismissal, and held that the above-quoted futility allegation satisfied the "particularity" requirement of Rule 23.1:

> "Recognizing both the general approach to the rules of pleading, which tends to minimize the requirements for specificity, as well as the particular requirements of Rule 23.1, . . . we have not the slightest difficulty in deciding that the allegations as to the reason why demand was not made upon the board of directors fully meet the requirements of the rule. The complainant clearly alleged 'with particularity' his 'reasons for his failure * * * for not making the effort,' whether or not the reasons may ultimately be found not to be fully supported."
> *Id.*

Clearly, petitioner herein has alleged with particularity the "approval of, ratification of, or acquiescence in" illegal transactions[11] by a majority of the Board. Hence, under the rationale of the Fifth (and Seventh) Circuit, petitioner has articulated within his pleadings the element of futility. *See Nelson v. Pacific South-*

[11] The illegal transactions et al. constitute inextricably linked federal and state law claims. *See* Complaint, para. 10; note 4, *infra*. The Third Circuit has reversed the dismissal of a like complaint, holding that the illegal act(s) itself prohibited such. *Miller v. American Telephone & Telegraph Company*, 507 F.2d 759 (3rd Cir. 1974).

west Airlines, 399 F.Supp. 1025 (S.D. Cal. 1975) (facts pleaded futility) (Ninth Circuit view).

Desipte the variance existing amongst the Circuits as to what constitutes Rule 23.1 particularization of futility, which has served to create a conflict of authority therein, the "lenient" viewpoint remains preferential. Consequently, based on the above, petitioners Complaint did in fact "adequately explain" futility and should not have been dismissed. The Petition for Certiorari should be granted to consider the policies and implications this decision presents.

II. Alternatively, if the Third Circuit Court of Appeals correctly interpreted Fed. R. Civ. P. 23.1's procedural "particularization" requirement, in dismissing this case it departed from the accepted and usual course of judicial proceedings by failing to remand the case to the District Court with leave to amend.

Although the Court of Appeals determined that the instant Complaint alleged a proper Section 10(b) cause of action, it affirmed the District Court's dismissal of this valid claim due to its additional finding that Rule 23.1's technical pleading requirement was not satisfied. Assuming, *arguendo*, that the Court correctly interpreted Rule 23.1's "particularization" standard, it is respectfully submitted that said court departed from the accepted and usual course of judicial proceedings by failing to remand this case to the District Court with lease to amend the Complaint.

Courts freely and consistently grant leave to amend in situations where the amendment would be curative of a defective or imperfect pleading. *Foman v. Davis*, 371 U.S. 178 (1962); *Gaffney v. Silk*, 488 F.2d 1248 (1st Cir. 1973); *Williams v. United States*, 405 F.2d 234 (5th Cir. 1968); *Ballou v. General Electric Company*, 393 F.2d 398 (1st Cir. 1968); *Harris v. Palm Springs Alpine Estates, Inc.*, 329 F.2d 909 (9th Cir. 1964); *Nagler v. Admiral Corp.*, 248 F.2d 319 (2d Cir. 1957); *McMinn County, Tennessee v. City of Athens, Tennessee*, 219 F.Supp. 705 (*E.D. Tenn.* 1963). Concomitantly, Fed. R. Civ. P. 15 requires that the right be granted freely as long as the amend-

ment is to be made in good faith and no prejudice results to the non-moving party. *Jensen v. Continental Financial Corporation,* 404 F.Supp. 792 (D.Minn. 1975). The rationale for this practice of allowing a plaintiff every opportunity to cure a defect in his pleadings is obvious:

> ". . . [T]he policy of deciding cases on the basis of the substantial rights involved rather than on technicalities requires that plaintiff be given every opportunity to cure a formal defect in his pleading. *This is true even though the court doubts that plaintiff will be able to overcome the defects in his initial pleading* . . . The better practice is to allow at least one amendment regardless of how unpromising the initial pleading appears . . ." (emphasis added)
> 5 *Wright & Miller, Federal Practice and Procedure,* §1357 (1969).
>
> * * *
>
> "If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claims on the merits."
> *Foman, supra* at 182.

See, McMinn County, Tennessee, supra.

Upon viewing the factual allegations of petitioner's Complaint (for purposes of the motion to dismiss the 10(b) claim)[12], the Court of Appeals held that neither control nor opposition to an action by the Audit Committee was shown. Consequently, futility was not "adequately explained". *Cramer, supra* at 93,991. In light of this technical defect, petitioner clearly should have been granted leave to amend. The defendants herein were put on notice of the petitioner's claims from the time the Complaint was filed. The petitioner seeks to add no new parties or causes of action by amendment. Therefore, the defendants cannot be prejudiced by the amendment. Nor

[12] The normal procedure in cases involving Rule 23.1's particularization requirement is to look "solely" to all factual allegations in the complaint. *See, e.g., De Pinto v. Provident Security Life Insurance Company,* 323 F.2d 826,830 (9th Cir. 1963), *cert. denied,* 376 U.S. 950 (1964); *Citrin v. Greater New York Industries, Inc.,* 79 F.Supp. 692,697 (S.D.N.Y. 1948). To consider materials and/or matters extraneous to the pleadings is to convert the motion to dismiss to one for summary judgment. *Mortensen v. First Federal Sav. and Loan Ass'n.,* 549 F.2d 884,891 (3rd Cir. 1977).

would petitioner be acting in bad faith, or employing dilatory tactics, in seeking leave to amend. The defect enunciated by the Court of Appeals that was the basis for its decision was neither raised by the defendants nor considered by the District Court. The petitioner was first put on notice of the possible defect in his pleadings when he received the decision of the Court of Appeals. Since the court concluded that the Complaint alleges a proper cause of action, "justice" and accepted judicial practices requires that leave to amend be granted. An amended complaint could then more specifically allege the "futility" of making a demand on the Board during the time period prior to the filing of this action.[13]

Accordingly, the Court of Appeals failure to remand with leave to amend was improper and violative of established judicial procedure.

CONCLUSION

For these reasons, a Writ of Certiorari should issue to review the judgment and opinion of the Third Circuit Court of Appeals.

Respectfully submitted,

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[13] Pursuant to Fed.R.Civ.P. 15(c), the amendment of the Complaint concerning the Rule 23.1 pleadings should relate back to the time the complaint was filed. The proposed Amended Complaint will refer to exactly the same occurence(s) that formed the basis for the original Complaint. The defendant was previously put on notice of the claim by the first Complaint. *Travelers Insurance Company v. Brown,* 338 F.2d 229 (5th Cir. 1964).

APPENDIX A

[¶ 96,510]

Cramer

v.

General Telephone & Electronics Corporation, et al.

United States Court of Appeals,

Third Circuit.

No. 77-2372.

July 18, 1978.

Appeal from the United States District Court for the Eastern District of Pennsylvania. Opinion in full text. Opinion amended to add attorney's names by order of August 8, 1978.

Exchange Act—Derivative Action—Res Judicata—Proxy Violations.—A shareholder's derivative action claim alleging violations of Section 14(a) of the Exchange Act was barred by the previous dismissal of another shareholder's derivative suit alleging the same violations. Although different shareholders brought the two actions, the actual plaintiff on whose behalf the claims were brought was the identical corporation. Thus, the doctrine of *res judicata* was applicable.

See ¶ 24,001, "Exchange Act—Proxies" division, Volume 2.

Exchange Act—Reports—False Statements—Causation.—Although a corporation's sale of its ownership interest in a foreign subsidiary qualified as a sale of securities, a shareholder's derivative action claim that the corporation was injured by the transaction failed to state a claim for relief under Section 18 of the Exchange Act because the sale was not made in reliance upon a false statement in an annual report filed by the corporation. Section 18 provides a civil remedy for damages resulting from the purchase or sale of a security in reliance upon a misleading statement in a document filed with the SEC. Absent that causal nexus, no cause of action was stated.

See ¶ 23,501, "Exchange Act—Registration; Reports" division, Volume 2 and ¶ 26,226, "Exchange Act—Insiders; Recordkeeping; Clearance & Transfer" division, Volume 3.

Exchange Act—Antifraud—Illegal Payments—In Connection With Requirement—Damages.—A claim that a corporation financed part of the purchase price on the sale of its ownership in a foreign subsidiary by paying commissions on future equipment sales sufficiently alleged that the fraud on the corporation occurred in connection with the purchase or sale of securities. The sale of the ownership interest constituted a sale of securities under the Exchange Act's antifraud provisions. Since the commission payments were inextricably linked to that sale, the alleged fraud occurred in connection with the sale of a security. Even assuming that the commission arrangement saved business for the corporation, the transaction may have injured the corporation. Thus, the district court erroneously concluded that no claim was stated under the antifraud provisions.

See ¶ 22,721 and 22,725, "Exchange Act—Manipulations; National Market System" division, Volume 2.

Exchange Act—Antifraud—Scienter—Knowledge.—A shareholder's allegation that the corporation's directors knowingly participated in a scheme to defraud the corporation sufficiently alleged scienter. If the directors intended to commit the acts which constituted a fraud upon the corporation, whether or not their acts were motivated by good faith is irrelevant.

See ¶ 22,721 and 22,725, "Exchange Act—Manipulations; National Market System" division, Volume 2.

Exchange Act—Antifraud—Derivative Action—Demand Requirement.—A shareholder's derivative action was dismissed because the complaint failed to allege either an adequate demand on the corporate directors to sue or a sufficient reason for failing to make that demand. The fact that an audit committee did not recommend litigation did not excuse the failure to comply with the demand requirement.

See ¶ 22,721 and 22,725, "Exchange Act—Manipulations; National Market System" division, Volume 2.

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GIBBONS, Circuit Judge: This is an appeal from the termination of a shareholder's derivative suit brought by Harold Cramer[1] on behalf of the shareholders of General Telephone & Electronics Corporation (GTE). The defendants are Leslie H. Warner, Theodore F. Brophy, John C. Douglas, and William Bennett, directors of the corporation, and Arthur Andersen & Co., GTE's auditors. In his complaint, the plaintiff contends that the defendants (1) violated Sections 10(b), 12(b)(1), 13(a), and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78l(b)(1), 78m(a), & 78n(a), and the regulations promulgated thereunder, (2) defrauded the corporation in violation of state law, and (3) breached their common-law fiduciary duties to the corporation. Plaintiff's Complaint, ¶ 10. The district court granted the defendants' joint motion for summary judgment on the §§ 13(a) and 14(a) claims on the ground that such claims were barred by res judicata. The court dismissed the claims under § 10(b), Rule 10b-5, and § 12(a) for failure to state claims upon which relief could be granted. Fed. R. Civ. P. 12(b)(6).

[1] Harold Cramer is the custodian of the GTE common stock for Patricia Gail Cramer, a minor. Plaintiff's Complaint, ¶ 1.

The state-law claims were dismissed on two grounds—res judicata and lack of subject matter jurisdictions. Although we disagree somewhat with the reasons underlying the district court's decision, we affirm its judgment in all respects.[2]

I.

The thrust of the plaintiff's claim is that the corporation was injured by the making of illegal overseas payments by GTE subsidiaries to foreign governmental officials and to private persons. The plaintiff contends that the defendants participated both in the making of the payments and in the failure to disclose the payments in reports disseminated to GTE stockholders. Paragraph 14 of the complaint contains the major allegations:

> 14. During a period commencing at a time unknown to plaintiff, and continuing at least until November, 1975, defendants, in violation of the Exchange Act and the Rules and Regulations promulgated thereunder and in violation of the Common law in connection with General participated, and/or acquiesced in, and/or aided and abetted, and/or failed to discover when in the exercise of due diligence they would have discovered, devices, schemes and artifices to defraud General, to waste the assets of General, to utilize the assets of General for unlawful purposes, to falsify the records of General, to defraud the United States Government by falsifying tax returns; to make untrue statements of material facts and to omit to state material facts in reports disseminated to shareholders of General; and, in the case of the individual defendants, breached their fiduciary duties and obligations to General.

Cramer rests his allegations largely on the findings which appear in a report on a special investigation conducted by the Audit Committee of the Board of Directors of GTE. That report, which is incorporated by reference in paragraph 15 of the plaintiff's complaint, was distributed to the shareholders as part of the proxy statement prior to the stockholders' annual meeting on April 21, 1976. The Audit Committee, which consisted

[2] The district court also denied the plaintiff's motion for a protective order. That decision is not before us on appeal.

of four outside directors who had not been involved in the questionable transactions, had been authorized by the Board of Directors to determine whether between January 1, 1971, and December 31, 1975, GTE or any of its international subsidiaries had made "illegal contributions, unlawful payments to domestic or foreign government officials or other payments which were otherwise improper or improperly recorded. . . ." Audit Committee Report [Exhibit A to Plaintiff's Complaint], at 13. The Committee was assisted by the Washington, D. C. law firm of Wilmer, Cutler and Pickering, which had never previously represented GTE, and by the accounting firm of Arthur Andersen, a defendant herein.

After investigating GTE's international operations for three months, the Audit Committee produced a 51-page report. That report, which was dated March 4, 1976, revealed that GTE and its subsidiaries had paid approximately $8 million to, or for the benefit of, foreign governmental officials. Most of these payments took the form of commercial kickbacks, rebates, or bribes to officials of private foreign customers. Another sum of approximately $2½ million was paid pursuant to a pre-January 1, 1971 commission arrangement between GTE officials and officers of a single foreign company (called the "Customer" in the Audit Committee's report). This commission arrangement stemmed from GTE's sale of its substantial ownership interest in the Customer to a private investment company controlled by a group of foreign nationals (the "Group"). The foreign government itself had urged GTE to make the sale. Since the purchasing group did not have adequate financial resources to acquire GTE's interest, GTE agreed to finance part of the purchase price by paying the Group commissions on future GTE equipment sales to the Customer. After being told that competitor would agree to such an arrangement if it declined to do so, GTE agreed to pay the commissions to a company designated by the purchasers and located in a third country.[3] Mem-

[3] The Audit Committee found that GTE International had paid the Group $373,872 in commissions and had applied another $2,271,481 in earned commissions to reduce the principal amount owed by the Group for its purchase of GTE's substantial interest in the Customer. In addition, as of December 31, 1975, GTE International had on its books $1,678,000 in accrued but unpaid commissions earned under this arrangement. Audit Committee Report, at 22.

bers of the Group became officers and directors of the Customer. Audit Committee Report, at 22.

The Audit Committee found that Warner, Brophy, Douglas, and Bennett, the defendants herein, had been involved, in varying degrees, "in the negotiation, formalization and implementation" of the commission arrangement described above. *Id.*. at 28. Bennett was found to be at least aware of two other questionable financial transactions. However, the Committee concluded that none of these directors profited personally from these payments and that all of them believed they were acting in the best interests of the corporation. *Id.* at 28-29. The Committee's report did not discuss the possibility of litigation against these directors, and its recommendations to the Board did not include the pursuit of such litigation.[4]

After the Audit Committee's report had been distributed to the GTE shareholders, three separate derivative suits were filed in different courts. The first of these was brought by Elias Auerbach, a GTE stockholder, against the same defendants as are named in the instant litigation. Auerbach's suit, which was filed in the Supreme Court of New York in Westchester County on March 16, 1976, alleged that the illegal payments constituted a waste of GTE's assets and that the defendants, by permitting such payments, had breached their fiduciary duties to the corporation. Two weeks later, Ralph Limmer filed another shareholder's derivative suit in the United States District Court for the Southern District of New York, charging that Warner, Brophy, Douglas and Bennett had violated §§ 13(a) and 14(a) of the 1934 Act and had breached their fiduciary duties to the shareholders. Arthur Andersen was not made a defendant in that action. Finally, on June 18, 1976, Cramer commenced the present suit in the United States District Court for the Eastern District of Pennsylvania.

[4] The Committee recommended only: (1) "that the Board instruct management to submit to the Board at an early date its plans to prevent a recurrence of the problems that have occurred," and (2) that GTE urge the United States Government to "mount a major political and diplomatic effort to formulate and enforce a common code of ethical standards for the conduct of international business." Audit Committee Report, at 30-31.

Cramer did not, before filing this suit, make a demand upon the GTE directors to institute the litigation. *See* Fed. R. Civ. P. 23.1. In paragraph 13 of this complaint, he alleges that such a demand would have been futile since the Audit Committee had not recommended litigation against the directors and since, in his opinion, the individual defendants dominated the Board of Directors.

On April 21, 1976, 1976, after the *Auerbach* and *Limmer* actions had been filed but before the instant action had been commenced, GTE's Board of Directors resolved to create a Special Litigation Committee to assess GTE's position with respect to the shareholders' derivative suits.[5] After Cramer had filed the instant lawsuit, the Board authorized the Committee to examine that suit too. The Committee consisted of three outside directors who had not been members of the Board of Directors at the time the events described in the Audit Committee's report occurred. Chief Judge Charles S. Desmond, now retired from the New York Court of Appeals, served as Special Counsel to the Committee.

After examining the work of the Audit Committee, the Special Litigation Committee made several findings and recommendations. The Committee found first that the investigation by the Audit Committee had been "complete, comprehensive and thorough." Special Litigation Committee Report, at 11. Judge Desmond informed the Committee members that in his opinion neither the state nor the federal claims were meritorious. The Special Litigation Committee advised GTE's General Counsel to take the position in *Limmer* and *Cramer* that the federal claims were meritless, that the state-law claims should be dismissed for lack of subject matter jurisdiction, and that the suits, even if meritorious, were not in the best interests of GTE or its shareholders and thus should not be prosecuted on GTE's behalf. The Committee recommended that the *Auerbach* action

[5] In forming this Committee, GTE's Board of Directors claimed that they were acting pursuant to § 712 of the New York Business Corporation Law and to § 20 of GTE's corporate by-laws.

be opposed as being contrary to the best interests of GTE or its shareholders.[6]

Relying on the conclusions of the Special Litigation Committee, the defendants moved to dismiss the complaints in *Auerbach* and *Limmer*. The state court dismissed Auerbach's complaint on the ground that this Committee's business judgment that the suit was not in GTE's best interests barred the prosecution of the suit. *Auerbach v. Bennett*, No. 572/77 (Sup. Ct. of New York, Westchester County, April 29, 1977). In *Limmer*, the district court dismissed the § 14(a) claim for failure to state a claim upon which relief could be granted. The § 13(a) claim was voluntarily withdrawn by the plaintiff and later dismissed with prejudice. Once the federal claims had been terminated, the district court dismissed the pendent state-law claims for lack of subject matter jurisdiction. *Limmer v. General Tel. & Elec. Corp.*, 76 Civ. 1494 (S. D. N. Y. March 11, 1977).

The defendants also moved to dismiss the complaint in the present case. The defendants claimed that all the federal claims were barred, under principles of res judicata and collateral estoppel, by the district court's decision in *Limmer*. The district court below agreed that Cramer's §§ 13(a) and 14(a) claims were barred by res judicata. However, because claims under §§ 10 (b) and 13(b)(1) require elements of proof different from those necessary under §§ 13 (a) and 14(a), the court concluded that those claims were not barred by *Limmer*. Nevertheless, the court dismissed the § 10 (b) and Rule 10b-5 claims on the grounds: (1) that the alleged fraud was not in connection with the purchase or sale of a security; (2) that GTE was not damaged by the fraudulent activities; and (3) that the plaintiff's complaint failed to allege that the defendants had intended to defraud the corporation. The § 12(b)(1) claim was dismissed because the plaintiff had not satisfied the standing re-

[6] The Committee also found (1) that the defendant directors had acted "with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. Special Litigation Committee Report, at 12, and (2) that Arthur Andersen had acted in accordance with accepted auditing standards and in good faith, *id.* at 14.

quirements of § 18(a) of the 1934 Act, 15 U. S. C. § 78r(a).[7] The state-law claims were dismissed for two reasons. First, the court concluded that those claims were precluded by the res judicata effect of the New York judgment in *Auerbach*. Secondly, even assuming that the claims were not barred by res judicata, the district court declined to exercise its pendent jurisdiction over those claims. *See United Mine Workers v. Gibbs*, 383 U. S. 715 (1966). The plaintiff filed a timely notice of appeal from the district court's decision.[8]

II. Section 14(a) Claim[9]

The doctrine of res judicata bars repetitious litigation of the same cause of action. As the Supreme Court has explained, the doctrine "rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations." *Commission v. Sunnen*, 333 U. S. 591, 597 (1948). Once a court of competent jurisdiction has entered a final judgment on the merits of a particular cause of action, the parties to that action are bound not only by every matter which was offered and considered in reaching that judgment, but also by every other matter which could have been offered. *Cromwell v. County of Sac*, 94 U. S. 351, 352 (1876); *Hubicki v. ACT Industries, Inc.*, 484 F. 2d 519, 524 (3d Cir. 1973). Absent

[7] The district court explained that part of its holding as follows:

> The complaint herein contains none of the allegations required to establish standing under § 18. There is no allegation that the corporation relied on any false or misleading filings in making any sale; there is no allegation that any filing affected the price of GTE securities. Finally, there is no causal nexus made, or even attempted, between any filing and any alleged loss which GTE suffered.

District Court Opinion at 14.

[8] On this appeal, Cramer does not contend that the district court erred in dismissing his § 12(b)(1) claim or his state-law claims. Thus, we need not decide the correctness of those dismissals.

[9] Section 14(a) reads:

> (a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

15 U.S.C. § 78N(a).

circumstances which would render inequitable the application of res judicata, a judgment on the merits will generally not be disturbed by a court in a subsequent suit involving the same parties.

We agree with the district court that the *Limmer* decision bars Cramer's § 14(a) claim against the directors. In *Limmer*, the district court granted the directors' motion to dismiss the plaintiff's § 14(a) claim. The court explained its decision as follows:

> Section 14(a), after all, contemplates the prevention, or redress, of such injury as would be, or is, directly traceable to a transaction authorized by a corporate electorate in the partial light of a misleading proxy solicitation. In the present case, by contrast, the damages claimed, if actually suffered, "flow from breach of a fiduciary obligation owed as a director or officer, rather than from any shareholder vote obtained by false proxy solicitation materials.

Limmer Opinion, at 4. Before a judgment can be given res judicata effect, both the parties and the issues in the prior and subsequent suits must be identical. *Expert Elec., Inc. v. Levine*, 554 F. 2d 1227, 1233 (2d Cir.) *cert. denied*, 46 U. S. L. W. 3262 (U. S. Oct. 11, 1977). Both of these conditions are satisfied here. Limmer's and Cramer's claims arose out of the same transactions. All four directors named as defendants in the instant case were defendants in *Limmer*. In a shareholder's derivative suit, the substantive claim belongs to the corporation. *See Ross v. Bernard*, 396 U. S. 531, 538-39 (1970). Although different shareholders brought the two actions, the actual plaintiff on whose behalf the claims were brought is the identical corporation, GTE. Since the *Limmer* court's dismissal of the § 14(a) claim is a final judgment on the merits and since the other requirements of res judicata are met, the plaintiff here cannot relitigate the § 14(a) claim against the directors in this or any other forum.

Cramer argues, however, that the individual defendants should be judicially estopped from asserting the res judicata bar of the *Limmer* judgment. In making this argument, Cramer re-

lies on a single letter sent by the defendants' counsel to the district court in response to a question from the court. In that letter, the relevant portion of which is quoted in the margin,[10] counsel stated that consolidation of the instant case with *Limmer* would be premature. Cramer contends that since in that letter the defendants' counsel stated that the parties and issues in the two suits differed, they should be estopped from contending now that the judgment in *Limmer* bars his claim under § 14(a). We agree with the district court that this argument "approaches absurdity." District Court Opinion, at 16. No motion was ever filed under 28 U. S. C. §§ 1404(a) or 1407 to transfer the instant case to the Southern District of New York or to consolidate the two actions. Thus, at the time the letter was written, the question of the similarities between the two suits was not squarely before the court. Since no question was ever directly before the court, we do not think that the principle of judicial estoppel should preclude the defendants from asserting the res judicata bar of *Limmer*.

The district court also held that Arthur Andersen was entitled to summary judgment on the § 14(a) claim by virtue of the *Limmer* decision. We agree, though we base our decision on collateral estoppel, not res judicata. Although Arthur Andersen would not have been bound by a judgment in *Limmer* adverse to the defendants, we think it is entitled to avail itself of a judgment favorable to those defendants. Mutuality of estoppel is no longer required for the principle of collateral estoppel to apply, at least "where the prior judgment is being invoked defensively in a second action against a plaintiff bringing suit on an issue he litigated and lost as plaintiff in a prior action." *Blonder-Tongue Laboratories, Inc. v. University Foundation*, 402 U. S. 313, 324 (1971). *See Bruszewski v. United States*, 181 F. 2d 419, 421 (3d Cir.), *cert. denied*, 340 U. S. 865

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[10] The last paragraph of this letter reads:

"Although it is conceivable that, should both actions survive Motions to Dismiss, consolidation or coordination of pre-trial discovery may be appropriate, where there are different parties and issues in the respective pleadings, and where motions to dismiss on jurisdictional grounds may dispose of the actions at the pleading stage, it is our view that any such consolidation or coordination would be premature and inappropriate at this time."

Letter from Joseph A. Tate, Esquire, to the Honorable A. Leon Higginbotham, dated September 10, 1976. App. at 363a.

(1950); *Bernhard v. Bank of America Nat. Trust & Sav. Ass'n,* 19 Cal. 2d 807, 122 P. 2d 892 (1942). *See generally* Currie, *Mutality of Collateral Estoppel: Limits of the Bernard Doctrine,* 9 Stan. L. Rev. 281 (1957). As long as the unsuccessful plaintiff had a full and fair opportunity to litigate the issue in the prior lawsuit, he will not be permitted to reassert the identical claim against a different defendant in a second suit. *Bruszewski v. United States,* 181 F. 2d at 421. The plaintiff in *Limmer* had a full and fair opportunity to litigate the § 14(a) claim in that forum. He had every incentive to prosecute vigorously the action against the individual defendants. There is no indication either that *Limmer* could not have recovered from the individual directors or that he could have recovered additional damages from Arthur Andersen. Under these circumstances, the judicial interest in avoiding repetitive litigation must prevail. Cramer is collaterally estopped from asserting the § 14(a) claim on behalf of GTE against Arthur Andersen.[11]

III. Section 13(a) Claim

In its opinion, the district court devoted very little attention to the effect of *Limmer* on Cramer's § 13(a) claim.[12] The court's entire discussion appears as follows:

> The claim asserted under § 13 was voluntarily withdrawn by the plaintiff in *Limmer* and dismissed with prej-

[11] Arthur Andersen contends that an independent auditor cannot be held liable under § 14(a) and Rule 14a-9, 17 CFR § 240.14a-9, which together impose liability for misleading statements on those who either solicit proxies or permit the use of their names in soliciting proxies. Since we hold that Arthur Andersen is entitled to avail itself of the protection of collateral estoppel, we need not consider this claim.

[12] Section 13(a) reads:

(a) Every issuer of a security registered pursuant to section 78*l* of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 78*l* of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

> udice pursuant to stipulation. *Limmer, supra,* page a, fn. 1. Defendant's Motion for Summary Judgment, June 7, 1977, page 23. Thus, res judicata bars Cramer's claims under both §§ 13 and 14a.

District Court Opinion, at 7.

Cramer contends that the district court erred in according full res judicata and collateral estoppel effect to the voluntary dismissal of the § 13(a) claim in *Limmer.* Relying on *Papilsky v. Berndt,* 466 F. 2d 251 (2d Cir.), *cert. denied,* 409 U. S. 1077 (1972), Cramer argues that in order for a voluntary dismissal in a derivative suit to bar a later derivative suit brought by a shareholder who was not a party in the first one, that shareholder must have had notice of the voluntary dismissal. We agree.

Rule 23.1 of the Federal Rules of Civil Procedure provides that a shareholder's derivative action "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs." The notice requirement of Rule 23.1 is not restricted to dismissals following settlements, but extends as well to voluntary dismissals under Rule 41(a). *Papilsky v. Berndt,* 466 F. 2d at 257; 3B J. Moore, Federal Practice 23.1.24 2 (1969). *See also Certain-Teed Prod. Corp. v. Topping,* 171 F. 2d 241, 243 (2d Cir. 1948) (applying notice requirement to plaintiff-shareholder's consent to entry of summary judgment against him). The wisdom of this rule is clear. Although a derivative action is brought by a single shareholder, the named plaintiff represents both the corporation itself and the entire class of stockholders. Notice is essential to ensure that the dismissal of the derivative action comports with the best interests of the corporation and its shareholders. If notice of a proposed voluntary dismissal were not required to be given to nonparty shareholders, the plaintiff or his counsel might be tempted to enter into a collusive settlement with the defendants. In addition, the notice requirement guards against dismissals which are due primarily if not entirely to the named plaintiff's change of heart about prosecuting the action. Finally, if notice were not required and if the

dismissal were to occur after the staute of limitations had run, the dismissal would bar any prosecution of the claim against the corporate officials. *Papilsky v. Berndt*, 466 F. 2d at 258. We conclude that before a shareholder's derivative action can be voluntarily dismissed, notice of the dismissal must be sent to nonparty shareholders. Absent such notice, the voluntary dismissal will not bar a subsequent action by a shareholder who did not participate in the prior suit.

The defendants claim, however, that Limmer's § 13(a) claim remained pending until it was involuntarily dismissed by the court. Since the claim was still pending, the defendants contend, the court was not required to give notice to nonparty shareholders. We find this argument unpersuasive. Limmer stipulated to the dismissal of his § 13(a) claim. The district court did not rule on the merits of Limmer's cause of action, but instead dismissed the claim with prejudice pursuant to that stipulation. Where the parties stipulate to the dismissal of a derivative action prior to any adjudication of the merits, all of the policies underlying the notice requirement are implicated. The district court's dismissal of the claim with prejudice magnifies the need for notice to the other shareholders. Since no notice was given, the voluntary dismissal cannot be given res judicata or collateral estoppel effect.

Any other result, we think, would raise serious due process questions. Nonparty shareholders are usually bound by a judgment in a derivative suit on the theory that the named plaintiff represented their interests in the case. But that rationale is valid only if the representation of the shareholders' interests was adequate. *Papilsky v. Berndt*, 466 F. 2d at 260. *Cf. Hansberry v. Lee*, 311 U. S. 32, 44-46 (1940). Rule 23.1 itself forbids a court from going forward with a derivative action "if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders. . . ." The voluntary dismissal of a cause of action raises some doubt as to whether the named plaintiff vigorously prosecuted that particular claim. The notice requirement of Rule 23.1 helps to ensure that the shareholders' interests are adequately represented in any dismissal prior to adjudication on the merits. Since notice of a proposed voluntary

dismissal must be sent to nonparty stockholders for that dismissal to be given res judicata and collateral estoppel effect, we need not decide whether Limmer adequately represented the interests of the stockholders.

Although Cramer's § 13(a) claim is not foreclosed by *Limmer*, the lower court's dismissal of that claim should nevertheless be affirmed. Section 13 is one of several statutory provisions requiring the filing of applications, documents, and reports with the Securities Exchange Commission. *See also* §§ 12(b), 12(g), 15(b)(1), 16(a), and 17(a) of the Act, 15 U.S.C. §§ 78*l*(b), 78*l*(g), 78o(b)(1), 78p(a), & 78q(a). In enacting § 13(a), Congress intended to protect investors by ensuring that they would receive adequate periodic reports concerning the operation and financial condition of corporations. *See* S. Rep. No. 792, 73rd Cong., 2d Sess. 11 (1934). Section 18, 15 U. S. C. § 78r, provides a civil remedy for damages resulting from the purchase or sale of a security in reliance upon a misleading statement in a document or report filed within the meaning of §§ 13(a) and 18, that *curities Litigation*, 347 F. Supp. 1327, 1340 (E. D. Pa. 1972), *modified in part*, 357 F. Supp. 869 (E. D. Pa. 1973), *aff'd*, 494 F. 2d 528 (3d Cir. 1974). Although GTE's sale of its ownership interest in the foreign subsidiary qualifies as a sale of securities with the meaning of §§ 13(a) and 18, that sale was not made in reliance upon a false statement in an annual report filed by GTE with the SEC. Absent that causal nexus, Cramer's complaint fails to state a cause of action in favor of GTE under these sections. In fact, at oral argument in this case, Cramer's counsel conceded that his complaint "probably did not" state a claim under § 13(a). Accordingly, we affirm the district court's entry of summary judgment in favor of the defendants on the § 13(a) claim.

IV. Section 10(b) and Rule 10b-5 Claims

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b),[13] and Rule 10b-5, 17 C. F. R. § 240.10b-5,[14] promulgated thereunder make unlawful the use of any deceptive or manipulative device in connection with the purchase or sale of a security. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U. S. 6 (1971). Where it is alleged that corporate officials have defrauded the corporation in connection with the purchase or sale of securities, a shareholder's derivative action under § 10(b) can be maintained against those officials. *See Pappas v. Moss*, 393 F. 2d 865, 869 (3d Cir. 1968). Such a derivative action can be maintained, however, only if the corporation itself was a purchaser or seller of securities. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723 (1975).

Cramer contends that the overseas payments by GTE's subsidiaries constituted a fraud on the corporation in violation of § 10(b) and Rule 10b-5.[15] Specifically, he argues that, be-

[13] Section 10(b) reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

[14] The text of Rule 10b-5 reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

[15] Although Cramer has asserted a § 10(b) claim on behalf of GTE against the defendants, neither Auerbach nor Limmer made comparable claims. Auerbach's failure to assert a § 10(b) claim is understandable, since federal courts have exclusive jurisdiction over suits alleging violations of this statutory provision. *See* § 27 of 1934 Act, 15 U.S.C. § 78aa; *Wolfson v. Blumberg*, 299 F. Supp. 191, 192 (S.D. N.Y. 1964), *appeal dismissed*, 340 F.2d 89 (2d Cir. 1965). Limmer brought suit in a federal forum, however, and thus could have asserted a § 10(b) claim if he had chosen to do so.

cause of these payments, GTE failed to receive adequate consideration for the sale of its equipment and, in one instance, for the sale of its ownership interest in a foreign company (the "Customer"). The district court concluded that GTE had bought or sold securities within the meaning of § 10(b) and thus that Cramer had standing to assert the claim on behalf of the corporation.[16] Nevertheless, the court dismissed the § 10(b) claim for three reasons:

> Cramer's § 10b and Rule 10b-5 claims against the defendants fail when the court asks whether the manipulative devices, the alleged fraud and the alleged breaches of fiduciary duty were *"in connection with"* the purchase or sale of any security and whether these activities resulted in any *damage* to GTE.
>
> * * *
>
> The complaint herein is devoid of any allegation that either the defendant officers, the Corporation or the accountants *intended* to defraud GTE.

District Court Opinion, at 11 and 13 (emphasis added). In our opinion, none of these grounds provides a sufficient basis for dismissing Cramer's complaint on a Rule 12(b)(6) motion.

A. *The "In-Connection-With" Requirement.*

The district court did not explain its statement that the allegedly fraudulent activities were not in connection with the purchase or sale of a security. Cramer contends that the court's conclusion is erroneous for two reasons. First, he urges that GTE's payment of commissions on its equipment sales to the

[16] In concluding that Cramer had standing to bring this claim, the district court noted first that a corporation's issuance of its own shares is a sale of securities within the meaning of § 10(b) and Rule 10b-5. *Securities & Exch. Comm'n v. National Sec., Inc.*, 393 U.S. 453 (1969). The court then stated:

> The complaint recites several instances in which GTE either bought or sold securities. In one transaction, GTE sold its substantial ownership interest in one subsidiary company to a group of foreign nations under a commission arrangement wherein GTE allegedly did not ultimately receive full value. [Complaint, Exhibit A, pp. 21-22]. Three other transactions are contained in GTE's 1975 Annual Report; in 1974 GTE offered 6,000,000 shares for public sale and issued 504,935 shares for exchange purposes; GTE purchased 4775 of its own shares in 1974.

District Court Opinion, at 11.

company designated by the foreign investors was part of the same financing package whereby GTE sold its ownership interest in the Customer to the Group. By paying commissions on the later sales, GTE allegedly paid the purchase price with its own funds and thus received inadequate consideration for the sale of its controlling interest in the Customer. This, Cramer alleges, constituted a fraud in violation of § 10(b) and Rule 10b-5. Secondly, Cramer claims that the other foreign payments disclosed in the Audit Committee's report were made in the "same general time frame" as sales of stock by GTE.

We need not decide the correctness of Cramer's second contention, for we conclude that the complaint sufficiently alleges that the commissions on the equipment sales were paid in connection with GTE's sale of its controlling interest in the Customer. As the district court stated, *see* footnote 12 *supra*, the sale of this ownership interest does constitute a sale of securities under § 10(b) and Rule 10b-5. The defendants claim that any damages to GTE caused by the commission arrangement were sustained in connection not with the sale of securities, but with the subsequent sales of equipment to the foreign company. We think that the defendants are taking a much too narrow view of the financing arrangement whereby GTE agreed to sell its interest in the Customer to the group of foreign investors. GTE's promise to pay commissions on equipment sales was not a separate agreement. Rather, that promise was an essential part of GTE's original agreement to sell its interest in the foreign company. The following excerpt from the Audit Committee report makes this connection abundantly clear:

> Since the Group did not have sufficient financial resources to purchase GTE's interest, it was agreed that GTE would finance a part of the purchase price by paying the Group a commission on sales of equipment by GTE to the Customer.

Audit Committee Report, at 22. Since the commission payments were inextricably linked to GTE's sale of its ownership interest in the Customer, we think the district court erred in concluding

that the alleged fraud was not alleged to be in connection with the sale of a security.

B. *Injury to GTE.*

Nor do we agree with the district court that GTE was not, for purposes of a Rule 12(b)(6) motion, injured by the allegedly fraudulent devices. In reaching this conclusion, we focus, as did the district court, on GTE's sale of its ownership interest in the foreign company. The Audit Committee found that GTE paid out approximately \$2½ million in commissions in connection with the sale of its interest in that company. GTE made these payments because the foreign investors were unable to finance the entire purchase price. In effect, GTE supplied some of the money which it received in exchange for its own stock. Surely, such a transaction, if proved, would establish a prima facie injury to the corporation.

The Audit Committee found that GTE entered into this arrangement only after it had been informed that, if it declined to do so, one of its competitors would agree to pay similar commissions. Relying on this finding, the district court concluded that without the commission arrangement GTE would not have been able to sell its equipment to the Customer. Since the commission arrangement in effect saved business for GTE, the court concluded, that arrangement did not damage GTE.

A complaint should not be dismissed under Rule 12(b)(6) "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). *See* 2A J. Moore, Federal Practice ¶12.08, at 2274 (2d ed. 1975). Applying this standard, we think the district court could not properly dismiss Cramer's complaint on the ground that GTE was not injured by the allegedly fraudulent activities. The Audit Committee did not find that the commission arrangement necessarily saved business for GTE. That Committee found only that GTE *was told* that if it did not enter into such an arrangement, one of its competitors would agree to a similar deal. The report does not indicate that GTE explored the veracity of the

investors' statement before it entered into the arrangement. It is quite possible that no competitor in fact offered to enter into a similar agreement. Even assuming that the commission arrangement saved business for GTE, we still cannot be sure, at this posture of the case, that GTE was not injured by the transaction. Neither the Audit Committee nor the district court compared the total amount of commissions with the profits generated by GTE's equipment sales to these foreign investors. Since no such comparison was undertaken, we cannot be certain that the commission arrangement benefited GTE. The district court could not properly terminate the claim at such an early stage on this ground.

C. *Allegation of Intent to Defraud.*

As stated earlier, a private cause of action will not lie under § 10(b) or under Rule 10b-5 unless the plaintiff alleges scienter—i.e., an intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). The district court concluded that Cramer's complaint failed to allege that the defendants intended to defraud the corporation. Relying on *Shemtob v. Shearson, Hammill & Co.,* 448 F.2d 442, 444-45 (2d Cir. 1971), it reasoned that the facts constituting both the fraud and the scienter must be alleged with particularity. District Court Opinion, at 13.

Under the Federal Rules of Civil Procedure, most complaints need be phrased only in general terms sufficient to put the defendants on notice as to the nature of the claims being asserted against them. *See* Fed. R. Civ. P. 8(a). However, Rule 9(b) imposes additional requirements where the complaint alleges fraud. That rule, which applies to claims alleging fraudulent activities in violation of the federal securities laws, *see Segal v. Gordon,* 467 F.2d 602, 606-08 (2d Cir. 1972); *Shemtob v. Shearson, Hammill & Co.,* 448 F.2d at 444-45, reads:

> (b) Fraud, Mistake, Condition of the Mind. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of a person may be averred generally.

The district court failed to recognize the differences between the two sentences of Rule 9(b). The first sentence of that rule requires that the complaint state with particularity the circumstances constituting the fraud. It was this part of Rule 9(b) which formed the basis for the dismissal of the complaint in *Shemtob*. But the problems with the complaint in *Shemtob* are absent here. Paragraph 15 of Cramer's complaint incorporates by reference the entire report of the Audit Committee. That report describes in detail the facts of the foreign payments, including the commissions paid in connection with GTE's sale of its ownership interest in the foreign company. By incorporating this committee's report, Cramer's complaint clearly satisfies the specificity requirement of the first sentence of Rule 9(b).

The second sentence of Rule 9(b) requires only that "intent, knowledge, and other condition of mind . . . be averred *generally*." (emphasis added). In paragraph 14 of this complaint, Cramer alleges that the "defendants . . . participated and/or acquiesced in, and/or aided and abetted, and/or failed to discover when in the exercise of due diligence they would have discovered, devices . . . to defraud General. . . ." Certainly, this general allegation of the defendants' state of mind meets the minimal requirements of the second sentence of Rule 9(b).

The defendants claim, however, that this allegation fails to meet the standard of *Ernst & Ernst v. Hochfelder*. We disagree. In *Ernst & Ernst*, the Supreme Court held that an allegation of negligence was insufficient to sustain a cause of action for damages under Rule 10b-5. The Court declined to determine whether recklessness could support such a cause of action. 425 U.S. at 194 n.12. We need not decide here whether an allegation of recklessness is sufficient under § 10b and Rule 10b-5, for we think that Cramer's complaint adequately alleges intent, at least

on the part of the individual directors.[17] The complaint alleges that the defendants knowingly participated in a scheme to defraud GTE. Indeed, the Audit Committee itself found that the four directors had been involved in the negotiation, formalization, and implementation of the commission arrangement. When corporate officials have actively participated in such a scheme with full knowledge of the consequences of their acts, such officials, we think, have acted with scienter within the meaning of *Ernst & Ernst. See In re Clinton Oil Co. Securities Litigation*, CCH SEC. LAW RPTR., ¶ 96,015 (D. Kan. March 18, 1977). The Audit Committee's finding that the directors did not profit secretly from these payments does not alter our conclusion. If the directors here intended to commit acts which constituted a fraud upon the corporation, whether or not their acts were motivated by good faith is irrelevant. Since we believe that the complaint adequately alleges scienter on the part of the directors, we cannot affirm the district court's dismissal of Cramer's § 10(b) and Rule 10b-5 claims on this ground.[18]

D. Shareholder's Demand on the Directors and the Business Judgment Rule

The defendants assert several grounds for affirmance which were not considered by the district court. Principally, they argue that the Special Litigation Committee's determination that Cramer's derivative suit is not in the best interests of the corporation bars the prosecution of this suit. The defendants emphasize that the directors who comprised that Committee were not part of inside management and had not served as directors when the questionable events occurred, thereby guaranteeing the independence of their determination. Moreover, the Committee acted in good faith and with the full authority of the Board of Directors. Accordingly, the defendants claim, that Committee's determination was a business judgment of GTE's management that the derivative suit should not proceed—a business judgment which is insulated from judicial review and which bars the maintenance of the derivative suit. *See Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976).

[17] Arthur Andersen claims that no set of facts could be proven to support a finding that it had the requisite intent to defraud GTE. While it seems very unlikely that Cramer could prove that Arthur Andersen intended to defraud the corporation, we nevertheless would be reluctant to dismiss the complaint on that ground at such an early stage of the proceedings. Since we are affirming the district court's dismissal of the complaint on a separate ground, we need not decide whether it sufficiently alleged scienter on the part of Arthur Andersen.

[18] Nor is it fatal to Cramer's complaint that he alleges negligence in addition to scienter. While under *Ernst & Ernst* Cramer could not recover damages under § 10(b) for mere negligence, we conclude that the remainder of paragraph 14 of the complaint adequately alleges scienter. Since at this stage we must construe the complaint liberally, we cannot dismiss the entire complaint simply because a single allegation is insufficient under the standard of *Ernst & Ernst*.

The business judgment rule originated as a means of limiting the liability of corporate directors and officers for mistakes made while performing their duties. Absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment, whether those mistakes are classified as mistakes of fact or mistakes of law. *See Briggs v. Spaulding*, 141 U. S. 132 (1891); 3A W. Fletcher, Corporations, ch. 11, § 1039 (1975 ed.). The rationale for the rule is that in order for the corporation to be managed properly and efficiently, directors must be given wide latitude in their handling of corporate affairs.

Some courts have applied the business judgment rule to bar a shareholder's derivative action where an independent board of directors has determined that such an action would not be in the best interests of the corporation. In *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U. S. 261, 263 (1917), the Supreme Court stated:

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment. . . .

This circuit previously considered the business judgment rule as a bar to shareholders' derivative suits in *Ash v. Inter-*

national Business Machines, Inc., 353 F. 2d 491, 492-93 (3d Cir. 1965), *cert. denied*, 384 U. S. 927 (1966), and in *Miller v. American Tel. & Tel. Co.*, 507 F.2d 759 (3d Cir. 1974). In *Ash*, a minority stockholder in three corporations competing with IBM sued IBM to enjoin it from acquiring another corporation. The plaintiff contended that this acquisition would substantially lessen competition in violation of Section 7 of the Clayton Act, 15 U. S. C. § 18. Because the directors of the three corporations had refused the plaintiff's demand that they sue IBM, we affirmed the district court's dismissal of the complaint. We held that in the absence of any showing that the directors' refusal to sue was collusive or in bad faith, the directors' business judgment barred the plaintiff's suit on behalf of the corporation. In *Miller*, stockholders in AT&T brought a derivative action against the corporation and its directors, alleging that the directors' failure to collect a $1.5 million debt from the Democratic National Committee constituted an illegal campaign contribution and a breach of the directors' fiduciary duty to the corporation. We acknowledged that the directors' judgment that the derivative action was not in the best interests of the corporation would normally bar the suit. 507 F. 2d at 762. Nevertheless, we reversed the district court's dismissal of the complaint, holding that where the "decision not to collect a debt owed the corporation is itself alleged to have been an illegal act," the directors' judgment cannot bar the derivative suit: *Id.*

The business judgment rule as a bar to a shareholder's derivative action is inextricably linked to the requirement in a number of jurisdictions that the plaintiff-shareholder first make a demand on the directors to pursue the claim. *See, e. g.*, Fed. R. Civ. P. 23.1; Colo. R. Civ. P. 231; N. Y. Bus. Corp. Law § 626(c) (McKinney 1963). Rule 23.1 of the Federal Rules of Civil Procedure requires that the shareholder's complaint "allege with particularity" either the efforts made to obtain the desired action from the directors or the reasons for not making such an effort. Once the shareholder has made a demand upon the directors, the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation.

Important policies underlie both the demand requirement and the business judgment rule as a bar to shareholders' derivative actions. The demand requirement enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation. Moreover, deference to the directors' judgment might terminate meritless causes of actions and prevent the corporation from incurring the costs of participating in derivative suits. Even if a particular suit has some merit, the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit. Finally, derivative actions could be brought not to remedy wrongs to the corporation, but to induce settlements beneficial to the named plaintiff or his counsel. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, (1976).

On the other hand, shareholders' derivative suits can be important weapons for remedying abuses of corporate management. Thus, while the demand requirement of Rule 23.1 should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from judicial review. In order for the directors' judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment. The opinions in *United Copper Securities Co.*,[19] and *Miller*[20] both suggest that courts have some limited power to review the

[19] Although the Supreme Court in *United Copper Securities Co.* deferred to the business judgment of the directors, the Court pointed out that there was not "even an allegation that [the directors'] action in refusing to bring suit [was] unwise." 244 U.S. at 264.

[20] Underlying the business judgment rule is the assumption that *reasonable diligence* has been used in reaching the decision which the rule is invoked to justify.

Miller v. American Tel. & Tel. Co., 507 F.2d at 762 (emphasis added).

reasonableness of the directors' judgment that a derivative suit is not in the best interests of the corporation.[21]

Neither *United Copper Securities Co., Ash,* nor *Miller* discusses in any depth whether state or federal law determines the effect of the business judgment rule on a Rule 23.1 derivative action. At oral argument in this case, both counsel argued that the law of the state of incorporation governs this question. To be sure, in *Miller* we applied the law of New York to determine whether the directors' judgment barred the derivative action. But the federal claim asserted in *Miller* was inextricably linked to the state law claim for wasting corporate assets. It is not at all clear that state law should determine the effect of the directors' judgment on a derivative action under the federal securities laws, where Congress has expressed a more comprehensive interest.[22]

In the instant case, we need not decide whether state or federal law governs the scope of review by a court of the business judgment decision not to pursue a cause of action. Nor do we have to decide whether the Special Litigation Committee's judgment should bar Cramer's derivative suit, for in our opinion the complaint should have been dismissed for failing to comply with the demand requirement of Rule 23.1. In *Shlensky v.*

[21] *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168, 196 (1976) (despite adverse business judgment, shareholder should be able to maintain a derivative action "where the corporation claim is clear, the costs of litigation are relatively small in relation to the probable recovery, and a lawsuit would not overly disrupt the commercial relation of the corporation"). Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,* 73 Harv. L. Rev. 746, 759 (1960) ("Certainly the court must respect the board's decision if it is within the broad bounds of reason, but the noninterference doctrine should not be carried to the extreme of making an unreasonable reference of the board dispositive of the issue.").

[22] It should be pointed out that a stockholder may maintain an action against a corporate insider under § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b). "If the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter. . . ." Thus, although a derivative action under § 16(b) cannot be brought unless the shareholder has first made a demand on the directors, the directors' decision not to prosecute the suit does not preclude a subsequent action by the shareholder himself.

We also take note of the Second Circuit's recent decision in *Lasker v. Burks,* No. 77-7060 (2d Cir. Jan. 11, 1978), which declined to apply the business judgment rule to bar a shareholder's derivative suit against the majority directors of a registered mutual fund and its investment adviser. To permit "independent" directors to bar such a suit, the court concluded, would be "contrary to the public interests which Congress sought to protect" by enacting the Investment Company Act and the Invesment Advisers Act. Slip Op. at 992-93.

Dorsey, Nos. 77-1156/57/58 (3d Cir. March 6, 1978), we affirmed a district court's dismissal of a defendant in a derivative action on the ground that the amended complaint failed to allege either an adequate demand on the corporate directors to sue that defendant or a sufficient reason for failing to make that demand. In affirming the dismissal, we stated that the amended complaint "failed to comply with the express requirements of Rule 23.1 which are mandatory. . . ." Slip Op., at 18. We reach the same conclusion here.

In paragraph 13 of his complaint, Cramer admits not having made a demand upon GTE's directors. He claims that such a demand would have been futile, however, since the Audit Committee had not recommended litigation against the defendants and since the individual defendants herein dominated the Board of Directors. Courts have sometimes permitted derivative actions to go forward without a demand on the directors where such a demand would have been futile and where the plaintiff-shareholder has alleged with particularity the reasons why a demand would have been futile. *See, e. g., Nussbacher v. Continental Illinois Nat. Bank & Trust Co.,* 518 F. 2d 873, 878-79 (7th Cir. 1975), *cert. denied,* 424 U. S. 928 (1976). In the instant case, however, Cramer's complaint does not adequately explain why he failed to make a demand upon the directors. Cramer correctly states that the Audit Committee did not recommend litigation against the directors. But so far as the complaint discloses, that Committee had not been instructed to determine whether litigation against the directors would be appropriate. Its primary functions were to examine GTE's foreign business transactions, to disclose any questionable overseas payments, and to suggest internal procedures for remedying the prior practices. We do not believe that the Audit Committee's report necessarily demonstrated management's opposition to an action against the directors who had participated in the foreign activities in which the payments had been made. To be sure, the Special Litigation Committee later opposed the maintenance of Cramer's derivative action. But that Committee's determination was made after Cramer had already commenced his suit. The futility of making the demand required by

Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight. At the time Cramer filed his complaint, the Board of Directors had not yet expressed opposition to such derivative actions.

Nor do we think that the defendants herein so dominated the Board of Directors as to make a demand on the Board futile. At the time Cramer commenced this suit, there were 14 individuals on GTE's Board of Directors. Only four of these were named as defendants in this action. The remaining ten directors had not been involved in the allegedly fraudulent activities. Indeed several of the directors had not even been members of the Board at the time the questionable transactions occurred. Under these circumstances, we cannot agree with Cramer that the four directors named as defendants in the instant case dominated the Board to such an extent that the plaintiff should be excused from the mandatory requirement of Rule 23.1 that he first make a demand on the directors.[23] Accordingly, we affirm the district court's dismissal of the Cramer's § 10(b) and Rule 10b-5 claims.[24]

V.

Cramer argues, however, that the district court should not have dismissed his complaint without affording him adequate discovery. But Cramer's claims were all dismissed because they are legally insufficient. We fail to see how additional discovery could have cured those insufficiencies. Thus, we conclude that the district court did not abuse its discretion in declining to grant the plaintiff additional discovery prior to dismissing his complaint.

VI.

The judgment appealed from will be affirmed.

[23] We do not hold that a shareholder, before instituting a derivative action, must always make a demand on the directors. But we do believe that unless the plaintiff's complaint alleges some facts tending to show why a demand would be futile, such a demand should be required, and the complaint should be dismissed.

[24] The defendants also urge that we affirm the district court's dismissal of the complaint on the grounds: (1) that the collateral estoppel of the *Auerbach* decision bars all of Cramer's claims; and (2) that since the plaintiff in *Limmer* could have brought a claim under § 10(b) and Rule 10b-5, Cramer is barred by res judicata from bringing such a claim now. Because we believe that Cramer's complaint should have been dismissed for failing to comply with the demand requirements of Rule 23.1, we need not consider these questions.

APPENDIX B

Harold CRAMER, custodian for
Patricia Gail Cramer

v.

GENERAL TELEPHONE &
ELECTRONICS et al.

Civ. A. No. 76-1231.

United States District Court,
E. D. Pennsylvania.

Aug. 22, 1977.

A shareholder derivative action was brought in which plaintiff alleged violations of various provisions of federal securities laws and breach of fiduciary duties. The District Court, Higginbotham, J., held, inter alia, that plaintiffs' claims were insufficient and should be dismissed.

Defendants' motion for summary judgment granted as to some claims and remaining claims dismissed.

1. Judgment—677

For purposes of judging applicability of doctrine of res judicata, two suits involved same parties where, in both cases, plaintiff sued derivatively on behalf of same corporation and claim pressed by each plaintiff against directors and third parties was not his own, but the corporation's.

2. Judgment—588

Court's decision with respect to shareholder's derivative suit charging violation of provisions of Securities Exchange Act of 1934 relating to solicitation of proxies did not, under doctrine of res judicata, bar assertion, in later derivative action against same corporation by different shareholder, of allegations that provisions of Act relating to use of manipulative or deceptive device in purchase or sale of securities and registration of securities on national securities exchange had been violated.

Securities Exchange Act of 1934, §§ 10(b), 12(b)(1), 13, 14(a) as amended 15 U.S.C.A. §§ 78j(b), 78l(b)(1), 78m, 78n(a).

3. Securities Regulation—120

Where corporate stockholder sued derivatively on corporations' behalf, and where complaint alleged that corporation itself either bought or sold securities, stockholder had standing to assert claim based on alleged violation of statute and rule relating to use of manipulative or deceptive device in purchase or sale of security. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

4. Securities Regulation—117

Corporate shareholder's derivative claim against corporation's officers and auditors that they had violated provisions of Securities Exchange Act of 1934 relating to use of manipulative or deceptive device in purchase or sale of security failed where corporation suffered no loss from transactions of which defendants were accused and where no such loss was alleged. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

5. Securities Regulation—139

Corporate stockholder, in his derivative action against corporate officers and auditors, failed to state valid claim for violation of provisions of Securities Exchange Act of 1934 relating to use of manipulative or deceptive device in connection with purchase or sale of security where, although it alleged that corporation had been mismanaged and that defendants' failure to disclose such mismanagement prior to publication of annual report was at heart of larger scheme to defraud corporation, there was no allegation that either defendant officers, the corporation or the auditors intended to defraud the corporation. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

6 Securities Regulation—117

No claim for relief could be maintained under provisions of Securities Exchange Act of 1934 relating to use of manipulative or deceptive device in purchase or sale of security based on negligence. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

7. Securities Regulation—137

Claim for violation of provisions of Securities Exchange Act of 1934 specifying information which issuer of securities must provide in application to register such securities failed where complaint did not allege that corporation on behalf of which suit was brought relied on any false or misleading filings in making any sale of securities, that any filing affected price of corporation's securities, or that there was any causal nexus between filing and alleged loss suffered by corporation. Securities Exchange Act of 1934, §§ 10(b), 12(b)(1), 18, 18(a) as amended 15 U.S.C.A. §§ 78j(b), 78l(b)(1), 78r, 78r(a).

8. Securities Regulation—122

Private cause of action would not lie for violation of provisions of Securities Exchange Act of 1934 specifying information which issuer of security must provide in application to register such security where statutorily required allegations cannot be made. Securities Exchange Act of 1934, §§ 10(b), 12(b)(1), 18, 18(a) as amended 15 U.S.C.A. §§ 78j(b), 78l(b)(1), 78r, 78r(a).

9. Federal Courts—18
Judgment—828(3.24)

Where prior decision in state court, which was valid final judgment involving same parties and same cause of action alleged as pendent claim in later derivative action brought by stockholder in federal court, was decided adversely to plaintiff in federal action, state court judgment barred pendent state claim in federal action under doctrine of res judicata; even if res judicata did not preclude consideration of such pendent state law claim, federal district court would decline to consider claim where plaintiff's federal claims under securities laws had been dismissed.

Mitchell A. Kramer, Kramer & Salus, Philadelphia, Pa., for plaintiff.

Arthur H. Kahn, Philadelphia, Pa. of counsel, for Warner, et al.

Oliver C. Biddle, New York City, for Arthur Andersen & Co.

Kaye, Scholer, Fierman, Hays & Handler, New York City, for defendants Brophy, Douglas and Warner.

Dean C. Rohrer, New York City, for General Telephone and Electronics, John Haikins, Pepper, Hamilton & Scheetz, Philadelphia, Pa., of counsel.

Morrison, Paul, Stillman & Beiley, New York City, for Wm. F. Bennett.

OPINION AND ORDER

HIGGINBOTHAM, District Judge.

This shareholder derivative action, alleging violations of Sections 10(b), 12(b)(1), 13(a) and 14(a) of the 1934 Securities and Exchange Acts as well as breach of fiduciary duties, was commenced by Harold Cramer on behalf of the shareholders of General Telephone & Electronics Corp. (GTE) against Leslie H. Warner, Theodore F. Brophy, John G. Douglas and William Bennett, corporate officers[1], and Arthur Andersen & Co., GTE's auditors. Jurisdiction is founded under § 27 of the 1934 Act, as amended, 15 U.S.C. § 78aa, 28 U.S.C. § 1332, and pendent jurisdiction.

Presently before the court are the following motions: plaintiff's motion for a Protective Order under Rule 26(c) of the Federal Rules of Civil Procedure; defendants' joint motion to dismiss the complaint for failure to state a claim for which relief can be granted under Fed. R. Civ. P. (12(b)(6); and, as an alternative, defendants' motion for summary judgment on

[1] The individual defendants held the following positions with GTE: Leslie H. Warner, Chairman of the Board of GTE, Theodore F. Brophy, President and Member of the Board of GTE; John J. Douglas, Executive Vice-President of Finance and Director of GTE; William F. Bennett, Executive Vice President of the Manufacturing Group and Director of GTE.

grounds that the complaint is barred by principles of res judicata and collateral estoppel.[2]

For the reasons stated herein, the motion for summary judgment is granted as to Sections 13(a), and 14(a) and the pendent state claims. The claims under Sections 10(b) and Rule 10b-5 and Section 12(a) are dismissed. Finally, plaintiff's motion for protective order is denied.

FACTUAL BACKGROUND

In view of the diversity and complexity of the claims asserted and the number of legal actions filed pursuant thereto, a review of the factual and legal history of this case is necessary.

Cramer, plaintiff herein, has alleged that the defendants "participated, and/or acquiesced in, and/or aided and abetted and/or failed to discover when in the exercise of due diligence they would have discovered devices, schemes and artifices to defraud . . . GTE." [Complaint, page 4 ¶ 14]. It is further alleged that: GTE's assets were unlawfully used; that corporate financial records and corporate tax returns were falsified; and that material facts were incompletely and/or inaccurately disclosed to GTE's shareholders. Plaintiff has maintained that GTE's 1976 Annual Report contains all the facts relevant to the claims he has asserted; he has incorporated that report into his complaint.

In November, 1975, GTE's Board of Directors authorized the formation of an Audit Committee composed solely of outside, non-management directors, to conduct an investigation to determine whether between January 1, 1971 and December 31, 1975, GTE or any of its international subsidiaries had made ". . . illegal political contributions, unlawful payments to domestic or foreign government officials or other payments which were otherwise improper or improperly recorded. . . ." [Complaint, Exhibit A, page 13]. The Washington, D.C. law firm of Wilmer, Cutler and Pickering (which had not previously repre-

[2] Defendant Arthur Andersen & Co. and nominal defendant GTE have joined the motion of defendants Warner, Brophy, Douglas and Bennett to dismiss the complaint and for summary judgment. See Documents Number 35 (filed June 9, 1977) and Number 36 (filed June 10, 1977).

sented GTE) and the accounting firm of Arthur Andersen & Co. were retained to assist this Committee.

The fifty-one page Audit Committee report, dated March 4, 1976, revealed that approximately $8,000,000 was illegally paid to or for the benefit of government officials as commercial kickbacks, rebates or bribes to officials of private foreign customers.[3] An additional sum, approximately $2,000,000, was paid pursuant to a pre-January 1, 1971 commission arrangement made between GTE officials and officers of a single foreign company, designated simply "The Customer" in the Audit Committee Report; GTE held a "substantial interest" in the company.[4]

This entire audit report was included in the 1976 Proxy Statement and distributed to all GTE shareholders before the Annual shareholder meeting was held on April 21, 1976. Both the report, and the Supplemental Report dated November 4, 1976, were filed with the SEC.

On March 16, 1976, Mr. Auerbach, a GTE shareholder, filed a derivative action against the corporate officials and Arthur Andersen in the Supreme Court of New York in Westchester County. He alleged that the illegal payments constituted a waste of GTE's assets, and that by permitting such payments, defendants breached their fiduciary duty to the corporation. *Auerbach v. Bennett,* Civil Action No. 572/77, Sup.Ct. of N.Y., Westchester Cty., April 29, 1977, p. 3.

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[3] The Committee concluded that $2,219,639.00 was paid directly to or for the benefit of government officials. It was further concluded that $5,086,028.00, representing portions of payments, were paid as commercial kickbacks, rebates or bribes. Said payments were made to officials of foreign customers. See Plaintiff's Complaint, Exhibit A at p. 27.

[4] As the Audit Committee Report indicates:

> "It [the Commission arrangement] arose out of the sale by GTE of its substantial ownership interest in the Customer, at the *urging of a foreign government,* to a group of foreign nationals (the "Group") in good standing with the government. Since the Group did not have sufficient financial resources to purchase GTE's interest, it was agreed that GTE would finance a part of the purchase price by paying the Group a commission on sales of equipment by GTE to the Customer. The *Group informed GTE that one of GTE's equipment competitors had offered to enter into such an arrangement if GTE was not willing to do so.* GTE ultimately agreed to pay sales commissions to a company designated by the Group and located in a third country. GTE subsequently sold its controlling interest in an investment company controlled by the Group; the stock of the customer is listed and traded on two stock exchanges in the United States and, according to the Audit Committee report, the commission agreement is no longer honored by GTE. Emphasis added. Complaint, Exhibit A, pp. 21-22.

Two weeks after the filing of the *Auerbach* suit, Mr. Limmer filed a derivative suit in the United States District Court for the Southern District of New York, charging that corporate officials had violated Sections 13(a) and 14(a) of the 1934 Securities and Exchange Act and had breached their fiduciary duty to shareholders. Warner, Brophy, Douglas and Bennett were named as defendants; Arthur Andersen & Co. was not made party to that suit. *Limmer v. GTE,* No. 76 Civ. 1494 (S.D.N.Y., March 11, 1977). Finally, on June 18, 1976, plaintiff herein commenced the instant litigation in this Court.

In order to assess GTE's position with respect to these actions, GTE's Board of Directors, acting pursuant to § 712 of the Business Corporation Law of New York and § 20 of the Corporate By-Laws, formed a Special Litigation Committee. The Committee was composed of three independent directors who had had no prior connection with GTE; Chief Judge Charles S. Desmond, now retired from the New York Court of Appeals acting as Special Counsel to the Committee. [Defendants' Motion for Summary Judgment, p. 5].

The Committee concluded that the defendants had satisfied their responsibilities under state law and that the three derivative actions were without merit. Moreover, the Committee determined that even if a cause of action could be said to exist, it would not be in GTE's best interests for any of the suits to be pursued by either GTE or the three named litigants. [Defendants' Motion for Summary Judgment, p. 5].

Based on the conclusions of GTE's Special Litigation Committee that the defendants had acted in good faith, that they had satisfied their fiduciary responsibilities, that the claims asserted in each derivative action were without merit, and that prosecution of these claims were not in the best interests of the corporation, GTE moved to dismiss the complaint in each suit. While motions to dismiss were pending in this suit, the complaints in *Auerbach v. Bennett* and *Limmer v. GTE,* were dismissed.

It is defendants' contention that *Auerbach v. Bennett* and *Limmer v. GTE* preclude this court's consideration of the in-

stant case under doctrines of res judicata and collateral estoppel. Plaintiff, on the other hand, argues that such a contention is both unfounded under applicable law and inconsistent with defendants' earlier position, stated in court on September 9, 1976, that the consolidation of *Limmer* and the instant case under 28 U.S.C. § 1407 would be inappropriate at that time.[illegible]

This Court will first determine whether plaintiff's federal claims are barred by the res judicata or collateral estoppel effect of the *Auerbach* and *Limmer* judgments. Because it appears that there are no viable federal claims, the pendent state law claims will not be reached by this court as the exercise of jurisdiction over pendent state law claims by a federal district court is discretionary. *United Mineworkers of America v. Gibbs,* 383 U.S. 715, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966); *Aldens, Ind. v. Packel,* 524 F.2d 38 (3d Cir. 1975), *cert. denied* 425 U.S. 943, 96 S.Ct. 1684, 48 L.Ed.2d 187 (1976); *Robinson v. Penn Central Co.,* 484 F.2d 553 (3d Cir. 1973). Cf. *Hagans v. Lavine,* 415 U.S. 528, 549-550, 94 S.Ct. 1372-1385, 39 L.Ed.2d 577 (1974).

RES JUDICATA: CLAIMS UNDER §§ 13 AND 14A

The doctrine of res judicata bars repetitious litigation. As the Court of Appeals for this Circuit reasoned in *Hubicki v. ACF Industries, Inc.,* 484 F.2d 519 (3d Cir. 1973):

> The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound not only as to every matter which was offered and received to sustain or defeat the claim on demand, but as to any other admissible matter which might have been offered for that purpose. [484 F.2d 524, citing *Commissioner v. Sunnen,* 333 U.S. 591, 597, 68 S.Ct. 715, 719, 92 L.Ed. 898 (1948).]

[illegible] In response to an inquiry made by the Court during oral argument held on September 9, 1976, Steven J. Glassman, Esquire, council for defendants Warner, Brophy and Douglas, indicated that consolidation of the two federal cases was inappropriate *at that time* because all defendants were not involved in both cases. Transcript, September 9, 1976, pp. 18-20. Plaintiff also cites a letter sent to the Court by Joseph A. Tate, Esquire, local council for the corporate defendants wherein Mr. Tate states that at the time in question, the presence of diverse parties in the litigation as well as the pendency of different jurisdictional challenges to the complaints suggested that, at least to the defendants, ". . . any such consolidation would be premature and inappropriate at this time." Letter to the court from Joseph A. Tate, Esq. September 10, 1976, last paragraph.

The inference of counsel's comment was that the defendants would also oppose a transfer under 28 U.S.C. § 1404(a).

As there can be no valid dispute that the *Limmer* judgment was a final adjudication on the merits of the issues presented, the threshold question for this Court is whether *Limmer* and *Cramer* involve the same parties and allege the same cause of action.

[1] I find that the *Limmer* suit and the present litigation involve the same parties. In both cases plaintiffs have sued derivatively in benalf of the corporation; the claim pressed by each shareholder against directors and third parties was not his own, but the corporation's. The United States Supreme Court ruled in *Ross v. Bernard,* 396 U.S. 531, 538-539, 90 S.Ct. 733, 738, 24 L.Ed.2d 729 (1970) that:

> The corporation is a necessary party to the action; without it the case cannot proceed. Although named a defendant, it is the real party in interest, *The stockholder being at best the nominal plaintiff*. [Emphasis added]

Thus, as plaintiffs in both *Cramer* and *Limmer* seek relief on behalf of GTE, the real party in interest, these actions involve the same plaintiff.

Although defendant Arthur Andersen was not named as a defendant in the *Limmer* case, in this case Arthur Andersen claims that like the other defendants, it is entitled to summary judgment by virtue of the res judicata effect of the *Limmer* decision. [Document # 36] Since plaintiff has not opposed the res judicata claim on the grounds that Arthur Andersen was not a party in the *Limmer* case [Document # 37], defendants herein will be considered as identical to those in *Limmer* for the limited purposes of considering the res judicata issues. Plaintiff is not prejudiced by this ruling even if plaintiff had opposed Arthur Andersen's joinder in the Motion for Summary Judgment, the § 10b claim asserted against the accountants must be dismissed because plaintiff has failed to allege scienter. [See discussion on § 10b, *supra*]

The operative facts in *Cramer* and *Limmer* are also identical. The complaints in both cases arise out of the same transactions reported by the Audit Committee Report.

Yet, although arising out of the same operative facts, only two of the federal claims are asserted in both complaints, namely that defendants violated §§ 13 and 14(a), and Rule 14a-9, of the 1934 Securities Act by failing to make full and complete disclosure of the illegal payments in proxy materials distributed to GTE shareholders between 1970 and 1975.

In *Limmer,* Judge Conner specifically held that even assuming plaintiff's factual allegations to be true, plaintiff had failed to state any claim upon which relief might be granted:

> Section 14(a), after all, contemplates the prevention, or redress of such injury as would be, or is, directly traceable to a transaction authorized by a corporation in the partial light of a misleading proxy solicitation. . . . In the present case, by contrast, the damages claimed, . . . flow from a breach of a fiduciary obligation owed as a director or officer, rather than from any shareholder vote obtained by false proxy solicitation materials. [citations omitted, *Limmer v. GTE, supra,* p. 4].

Thus, the *Limmer* court dismissed the § 14(a) claim.

The claim asserted under § 13 was voluntarily withdrawn by the plaintiff in *Limmer* and dismissed with prejudice pursuant to stipulation. *Limmer, supra,* page a, fn, 1. [Defendant's Motion for Summary Judgment, June 7, 1977, page 23.] Thus, res judicata bars Cramer's claims under both §§ 13 and 14(a).

[2] Defendants herein forcefully argue that the doctrine of res judicata also precludes plaintiff's claims under § 10(b), (and Rule 10b-5) and § 12(b)(1), even though the plaintiff in *Limmer* did not assert a claim under those sections of the 1934 act. Defendants maintain that "... the central element of a claim under each of these sections of the 1934 Act is that the defendant misled the plaintiff by making false statements of material fact or omitting to state material facts necessary to make the statement made not false or misleading." [Defendants' Motion for Summary Judgment, p. 23]. Thus, they urge that when ruling on the § 14(a) claim, the court was holding in effect that there were no meritorious claims under §§ 10(b) and 12(b)(1).

While it is true that the overriding purpose of the 1934 Securities Act was to protect investors against manipulation of stock prices by regulation of securities transactions [S.Rep.No. 792, 73d Cong., 2d Sess., 1-5 (1934), it is not true, as defendants would have this court hold, that § 10(b) and § 14(a) are identical causes of actions. Section 10(b) makes it:

> unlawful for any person . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j.

Section 14(a), on the other hand, speaks not to the purchase or sale of a security, but to the solicitation of proxies. This section provides that:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest . . . , to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to section 781 of this title. 15 U.S.C. § 78n(a).

Because the elements necessary to make out a § 10(b) claim differ from those necessary to establish a § 14(a) violation, a finding that defendants did not violate § 14(a) should not preclude the other claim. In order to successfully maintain a cause of action under § 14(a), a plaintiff must allege that specific proxy statements were materially false and misleading, that there was a causal connection between the alleged violation of the proxy rules, and the injury suffered by the plaintiff. *T.S.C. Industries, Inc. v. Northway,* 426 U.S. 438, 96 S.Ct. 2126, 48

L.Ed.2d 757 (1976); *J. I. Case v. Borak*, 377 U.S. 426, 431, 84 S.Ct. 1555, 1559, 12 L.Ed.2d 423 (1964). This was the standard applied by the *Limmer* court, which found that the plaintiff had not met these requirements.

A successful § 10(b) derivative action requires plaintiff to show the following: that the corporation was a purchaser, or seller of securities, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975); that the alleged fraud or manipulative device was employed in connection with the purchase or sale of the security, *Superintendent of Insurance v. Bankers Life and Casualty*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed2d 128 (1971); *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194, (3d Cir. 1976); and that the defendants herein had intended to deceive, manipulate or defraud the corporation, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 1381, 47 L.Ed.2d 668 (1976).

A finding that defendants did not distribute a materially misleading proxy statement is not a *fortiori* a finding that as a purchaser or seller of securities, GTE was intentionally defrauded by the defendants through use of a manipulative device employed in connection with the purchase or sale of the security.

Defendants argue that the instant case is on all fours with, and controlled by, the Third Circuit's decision in *Williamson v. Columbia Gas and Electric Corp.*, 186 F.2d 464 (3d Cir. 1950), reaffirmed by that Court in 1968 in *Clements v. Central Railroad Company of New Jersey*, 399 F.2d 825 (3d Cir. 1968). The Court, *per* Justice Goodrich, reasoned that one claim against the defendant under Sections 1 and 2 of the Sherman Act and a second claim under Section 7 of the Clayton Act involved identical causes of action for purposes of res judicata:

> . . . the fact that different statutes are relied on does not render the claims different "causes of action" for purposes of res judicata. 186 F.2d 468.

However, a comparison of the *Williamson* case with *Cramer* and *Limmer* reveal that these factual situations are not truly analogous. The court in *Williamson* found that "[w]hether Co-

lumbia is sought to be held as sole tortfeasor or sued singly as one of several tortfeasors, assuming the injury is the same, does not matter." 186 F.2d at 468. Yet, in the instant case, the injury and damage to GTE alleged under § 10(b) of the 1934 Securities Act is *not* the same as that which must be shown under § 14(a).

Because of the complexity of the record and the requirement that plaintiff allege scienter, defined by the Supreme Court in *Ernst & Ernst v. Hochfelder, supra*, as ". . . a mental state embracing intent to deceive, manipulate or defraud." [425 U.S. 185, 194, 96 S.Ct. 1375, 1381, 47 L.Ed.2d 668], this court is reluctant to accord res judicata effect to the *Limmer* decision on § 14(a) to bar the § 10(b) claim. This court is guided by the United States Supreme Court decision in *Lawlor v. National Screen Service Corp.*, 349 U.S. 322, 75 S.Ct. 865, 868, 99 L.Ed. 1122 (1955) that a judgment, "unaccompanied by findings . . . [does] not bind the parties on any issue . . . which might arise in connection with another cause of action." The Court further ruled "[t]hat both suits involved 'essentially the same course of wrongful conduct' is not decisive. Such court of conduct . . . may frequently give rise to more than a single cause of action." Defendants also argue that *Limmer* bars the § 12(b)(1) claim. That assertion is also incorrect.

In conclusion, the decision of the *Limmer* court does not preclude either the § 10(b) or the § 12(b)(1) claim in the instant case.

ALTERNATIVE GROUNDS FOR DISMISSAL OF THE § 10B CLAIM

Defendants have made a motion in the alternative, seeking a dismissal of the § 10(b) claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.

[3] Plaintiff has standing to assert § 10(b) and Rule 10b-5 claims in behalf of GTE against the defendants. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), the Supreme Court limited standing under

§ 10(b) and Rule 10b-5 to one who is a purchaser or seller of securities; in cases where plaintiff sues derivatively the corporation must be a purchaser or seller of securities. *Blue Chip Stamps*, 421 U.S. at 738, 95 S.Ct. at 1926, citing to *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219 (2d Cir. 1968), *cert. denied* 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed.2d 219 (1969); *Pappas v. Moss*, 393 F.2d 865, 870 (3d Cir. 1968). For § 10(b) and Rule 10b-5 purposes, the issuance by a corporation of its own shares constitute a sale of securities. *SEC v. National Securities, Inc.*, 393 U.S. 453, 89 S.Ct. 564, 21 L.Ed.2d 668 (1969); *In re Penn Central Securities*, 347 F.Supp. 1327, 1333 (E.D.Pa.1972).

The complaint recites several instances in which GTE either bought or sold securities. In one transaction, GTE sold its substantial ownership interest in one subsidiary company to a group of foreign nationals under a commission arrangement wherein GTE allegedly did not ultimately receive full value. [Complaint, Exhibit A, pp. 21-22]. Three other transactions are contained in GTE's 1975 Annual Report: in 1974 GTE offered 6,000,000 shares for public sale and issued 504,935 shares for exchange purposes; GTE purchased 4775 of its own shares in 1974.

[4] Cramer's § 10(b) and Rule 10b-5 claims against the defendants fail when the court asks whether the manipulative devices, the alleged fraud and the alleged breaches of fiduciary duty were "in connection with" the purchase or sale of any security and whether these activities resulted in any damage to GTE. *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194 (3d Cir. 1976), relying on *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971); *Thomas v. Duralite Company, Inc.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros., Inc. v Rhoades*, 491 F.2d 402 (3d Cir. 1974).

Even assuming that the defendants' purported manipulative devices were employed in connection with either the 1975 issuance and offering or the 1974 purchase of shares, GTE suf-

fered no loss from these transactions; moreover, no such loss was alleged.

However, the sale of GTE's substantial interest in its subsidiary to a group of foreign nationals raises the question of whether any claim for relief has been stated against the defendants under § 10(b) and Rule 10b-5 based on GTE's commission agreement. Under this agreement, GTE financed a part of the purchase price by paying the group a commission on sales of equipment made by GTE to the customer.

The 1976 Annual Report is alleged to contain the facts which form the basis of the complaint. [Complaint, ¶ 15]. In that report, GTE's investigation of the commission arrangement is examined in great detail. That investigation revealed that GTE entered the agreement when the corporation was informed by the foreign group that one of GTE's competitors had agreed to enter such an arrangement if GTE refused to do so. The commission arrangement has since been terminated. Although the amount paid to the foreign company was considerable, the Audit Committee Report indicates that this arrangement may have saved that business for GTE.

[5] Cramer's theory is that the corporation has been mismanaged and that the defendant's failure to disclose such mismanagement prior to publication of the 1976 Annual Report was at the heart of a larger scheme to defraud the corporation. Although § 10b was not intended to cover situations involving "internal corporate mismanagement," the Supreme Court recognized in *Superintendent of Insurance v. Bankers Life & Casualty Co., supra*, 404 U.S. at 12, 13, 92 S.Ct. 165, that a corporation could suffer an injury as a result of deceptive practices which touched a corporation's sale or purchase of its own securities.

Even assuming that defendants' actions could be said to be corporate mismanagement which "touched" the sale or purchase of a security, *Ernst & Ernst v. Hochfelder, supra*, limits § 10(b) and Rule 10b-5 actions to those in which a defendant exhibits "... a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 96 S.Ct. at 1381, fn. 12;

Straub v. Vaisman & Co., Inc., 540 F.2d 591, 597 (3d Cir. 1976).

The complaint herein is devoid of any allegation that either the defendant officers, the Corporation or the accountants intended to defraud GTE. In averments of fraud, the circumstances constituting fraud must be stated with particularity; "[i]n the absence of allegation of facts amounting to fraud or scienter . . . mere conclusions are insufficient . . .". *Shemtab v. Shearin, Hamill & Co.*, 448 F.2d 442, 444-445 (2d Cir. 1971). *Accord Seligson v. Plum Tree, Inc.*, 361 F.Supp. 748 (E.D.Pa. 1973).

[6] While it may be that the corporation and the individual defendants were negligent because the questionable practices were not discovered earlier, no claim for relief can be maintained under § 10 and Rule 10b-5 for negligence. The § 10(b) claim is therefore dismissed.

SECTION 12(B)(1)

[7] Plaintiff has also alleged a violation of Section 12(b)(1), which specifies the information an issuer must provide in an application to register a security.[6] In order to suc-

[6] Section 12(b)(1) [15 U.S.C. § 78*l*(b)(1)(A)—(L)] provides:

(b) A security may be registered on a national securities exchange by the issuer filing on application with the exchange (and filing with the Commission such duplicate originals thereof as the Commission may require), which application shall contain—

(1) Such information, in such detail, as to the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer, and any guarantor of the security as to principal or interest or both, as the Commission may by rules and regulations require, as necessary or appropriate in the public interest or for the protection of investors, in respect of the following:

(A) the organization, financial structure, and nature of the business;

(B) the terms, position, rights, and privileges of the different classes of securities outstanding;

(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;

(D) the directors, officers, and undrwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

(E) remuneration to others than directors and officers exceeding $20,000 per annum;

(F) bonus and profit-sharing arrangements;

cessfully maintain an action under § 12(b)(1), a plaintiff must meet the standing requirement of § 18 which limits the ability to maintain a § 12(b)(1) claim to only those plaintiffs who purchased or sold a security in reliance upon information filed as required by § 12 or § 13, whose purchase or sales price was affected by said information, and who had no knowledge of omissions from or misrepresentations in the report.[7] As Chief Judge Lord stated in *In re Penn Central Securities Litigation*, 347 F.Supp. 1327, 1340 (E.D.Pa.1972), *petition for reconsideration denied*, 357 F.Supp. 869, 876, aff'd, 494 F.2d 528, (3d Cir. 1974):

(G) management and service contracts;

(H) options existing or to be created in respect of their securities;

(I) material contracts, not made in the ordinary course of business, which are to be executed in whole or in part at or after the filing of the application or which were made not more than two years before such filing, and every material patent or contract for a material patent right shall be deemed a material contract;

(J) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(K) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(L) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

[7] 15 U.S.C. § 78r:

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78*o* of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person, who, if joined in the original suit, would have been liable to make the same payment.

(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

where Congress has specifically authorized a remedy for violation of an act, the courts should not nullify the congressional scheme by implying a right of action on behalf of those not otherwise entitled to recover.

The complaint herein contains none of the allegations required to establish standing under § 18. There is no allegation that the corporation relied on any false or misleading filings in making any sale; there is no allegation that any filing affected the price of GTE securities. Finally, there is no causal nexus made, or even attempted, between any filing and any alleged loss which GTE suffered.

[8] It is suggested by plaintiff that *Kerber v. Kakos*, 383 F.Supp. 625, 631 (N.D.Ill. 1974), supports the position that a private cause of action will lie even when the § 18 requirements have not been completely satisfied. However, such reliance is misplaced; in *Kerber v. Kakos*, the court implied a cause of action under § 12(b) *only* in a case where the issuer had completely ignored the registration requirements. That situation is distinguishable from the case where the issuer is alleged to have made a false and misleading statement. 383 F.Supp. at 631. The *Cramer* case falls into the latter category.

In sum, as plaintiff has failed to meet the standing requirements of § 18(a), plaintiff's claims under 12(b)(1) must be dismissed.

PENDENT STATE CLAIM

[9] The decision of the state court in *Auerbach v. Bennett* holds that as a matter of New York state law none of the defendants breached the fiduciary duty owed to GTE. The court also ruled that pursuant to the business judgment rule, GTE's decision not to maintain any legal action was proper. *Auerbach v. Bennett* was a valid final judgment involving the same parties and the same cause of action alleged by Cramer. Therefore, the New York judgment bars the instant plaintiff's pendent state claim under the doctrine of res judicata.

And, even if res judicata did not preclude consideration of plaintiffs' state law claims, this court, pursuant to the doctrine of pendent jurisdiction, declines to consider these claims. For, as the Supreme Court held in *United Mineworkers of America v. Gibbs*, 383 U.S. 715, 726, 86 S.Ct. 1130, 1139, 16 L.Ed.2d 218, 228 (1966);

> . . . it has consistently been recognized that pendent jurisdiction is a doctrine of discretion, not of plaintiff's right . . . [and . . . if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well.

See also Broderick v. Associated Hosp. Serv. of Philadelphia, 536 F.2d 1 (3d Cir. 1976); *Deaktor v. Fox Grocery Co.*, 475 F.2d 1112 (3d Cir. 1973), *cert. denied* 414 U.S. 867, 94 S.Ct. 65, 38 L.Ed.2d 86.

I am not unaware that a a final alternative plaintiff asserts that he should be entitled at least to further discovery to accumulate evidence which might contradict the findings of Judge Conner in *Limmer v. GTE* or the findings of the Special Audit Committee, or the decision of the New York state court in *Auerbach v. Bennett*. On the surface, a request merely for additional discovery has a certain appeal. But upon analysis, the claim for more discovery can be made forever by any stockholder who chose not to join the first law suit and instead wanted to go it alone. Plaintiff knew of the New York law suit; the forum was not patently inconvenient; the issues were clear; it was beyond dispute that it was a derivative stockholders' suit; there is no allegation of fraud or incompetence on the part of the plaintiffs in litigating the case.

I am also not unaware of plaintiff's argument that defendants are judicially estopped from raising the res judicata argument. In response to a query from the bench, defendants indicated their resistance to a consolidation of the *Cramer* and *Limmer* cases. But, no motion was ever filed for a transfer or consolidation under 28 U.S.C. §§ 1404(a) and 1407. And, it approaches absurdity for a court to rule that defense counsel

should be estopped because plaintiff's counsel relied on positions taken on issues not squarely before the court.

PLAINTIFF'S MOTION FOR A PROTECTIVE ORDER

The dismissal of plaintiff's §§ 10(b) and 12(b)(1) claims, and the grant of summary judgment against plaintiff as to the §§ 13 and 14(a) and pendent state law claims requires a denial of plaintiff's motion for a protective order.

CONCLUSION

An analysis of the *Cramer* complaint reveals that plaintiff attempted to base federal securities law claims on acts which are arguably unwise from a business standpoint and probably, in so far as the alleged bribes are concerned, questionable from any ethical standpoint. However, our role is not to write a code of ethics for businessmen. Hopefully, they should strive for a level of morality beyond reproach. But the sad fact is that their faltering moral standards may not necessarily constitute a loss or a fraud on the corporation. Some corporations reach new economic plateaus not because of their morality but despite it.

In conclusion, therefore, defendants' motion for summary judgment is granted as to claims made pursuant to §§ 13 and 14(a) of the 1934 Securities and Exchange Act and as to the pendent state law claims. The §§ 10(b) and 12(b)(1) claims are dismissed. And, plaintiff's motion for a protective order is denied.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 77-2372

Cramer, Harold, Custodian for Cramer, Patricia Gail,
Appellant,

v.

General Telephone & Electronics Corporation and Warner, Leslie H., Brophy, Theodore F., Douglas, John J., Bennett, William F., Arthur Andersen & Co.

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge*, ALDISERT, ADAMS, GIBBONS, ROSENN, HUNTER, WEIS, GARTH and HIGGINBOTHAM, *Circuit Judges*

The petition for rehearing filed by

Appellant

in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

Dated: August 28, 1978 Judge

APPENDIX D

Rule 23.1 Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.